Review of
Pacific Gas and Electric Company
Financial Condition

January 30, 2001

For the California Public Utilities Commission

Barrington-Wellesley Group, Inc.

New London, NH 03257

TABLE OF CONTENTS

TABLE OF CONTENTS
(Continued)

LIST OF EXHIBITS

LIST OF EXHIBITS
(Continued)

CHAPTER I

Executive Summary

On December 21, 2000, the CPUC issued Decision 00-12-067, which required that the California Public Utilities Commission (CPUC) hire an independent auditor to determine the veracity of PG&E's claims of financial distress and to assess Pacific Gas & Electric's (PG&E) financial condition. On January 4, 2001, in Decision 01-01-018, the CPUC granted an interim rate allowing PG&E to increase its electric bill for each customer by one cent per kilowatt-hour (kWh) applied on a usage basis for the 90 days from the date of the order. Customers eligible for California Alternative Rates for Energy (CARE) are exempt from this surcharge. During that 90 day period, the CPUC indicated it would conduct further proceedings and investigations and that the independent auditor would complete its review of PG&E's financial position, as well as that of its holding company and its affiliates. The Barrington-Wellesley Group, Inc. (BWG), which was selected to perform the independent review of PG&E, initiated its review on December 26, 2000.

As requested by the CPUC, BWG's review of PG&E's financial condition covers the following areas:

- Credit and Default Relationships (Chapter II)
- Power Purchases and Cash Flows (Chapter III)
- Cash Conservation Activities (Chapter IV)
- Accounting Mechanisms to Track Stranded Cost Recovery (TCBA and TRA) (Chapter V)
- Inter-Company Cash Flows (Chapter VI)
- Affiliate Earnings in the California Energy Market (Chapter VII)
- 2000 Federal Income Tax Refund (Chapter VIII)

SUMMARY OF FINDINGS AND CONCLUSIONS

CREDIT AND DEFAULT RELATIONSHIPS (CHAPTER II)

- PG&E has made accurate representation of its borrowing capability, credit condition and potential events of default. PG&E cannot obtain the credit it requires. On November 1, 2000, PG&E amended its unsecured medium term notes, its floating rate notes and its senior notes, and on December 1, 2000, PG&E

amended its credit agreement. Under PG&E's amended and restated credit agreement dated December 1, 2000, a provision was added whereby if PG&E's credit ratings fall below minimum investment grades, it is in default. On January 17, 2001, PG&E's credit ratings did fall below minimum investment grades and thereby PG&E is now in technical default of these credit agreements.

- Since the holding company was formed, PG&E Corp. has not provided cash, credit or other financial assistance or support to PG&E.

- PG&E Corp. has taken actions to separate certain assets and liabilities of National Energy Group (NEG) to remove it from default in the event of bankruptcy or default by PG&E or PG&E Corp.

PG&E Debt

PG&E's outstanding debt principal and interest payments in 2001 total $3.2 billion. PG&E has exhausted its borrowing capability under existing lines of credit. Because bond rating agencies have lowered PG&E's credit rating to below investment grade, PG&E is technically in default of some of its loan agreements, which have provisions triggering default when PG&E's credit rating falls below a certain level.

Although rating notice provisions are included in PG&E loan agreements from as far back as November 29, 1993, a ratings threshold as an event of default did not appear until 2000. The January 17, 2001 ratings downgrade by both S&P and Moody's resulted in below minimum investment grade ratings for PG&E Corp. and PG&E. Ratings below investment grade constitute an event of default under the PG&E Corp. bank lines of credit agreements and under one of PG&E's bank line agreements. Beginning January 16, 2001, the banks have refused to allow drawdowns under the PG&E and PG&E Corp. credit agreements and the companies are not paying maturing commercial paper as it becomes due.

While PG&E theoretically has potential borrowing capabilities under its first mortgage bonds, it is unlikely that lenders will extend additional credit to PG&E under current conditions. PG&E's credit agreements do not contain provisions that require periodic amendments, but they are often renewed or extended through amendments.

PG&E Corp. (Holding Company) Debt

PG&E Corp. has long-term and short-term debt outstanding under its loan agreements with banks totaling $1 billion. Based on its cash forecasts, PG&E Corp. will exhaust its borrowing capability under its credit facilities by March 31, 2001, as its outstanding commercial paper becomes due. As of March 31, 2001, PG&E Corp. projects its available cash to be $340 million. Absent an acceleration of its short-term debt, PG&E Corp. has the cash it needs to support its operations for an extended period.

Default by PG&E under its loan agreements would constitute an event of default for PG&E Corp. under its agreements. The PG&E Corp. credit agreement dated August 26, 1997, has a rating agency trigger as an event of default. Provisions of the CPUC order approving the formation of the PG&E Corp. holding company require that the PG&E Corp.'s Board of Directors give first priority to PG&E's capital requirements to meet its obligation to serve. PG&E interprets this requirement to pertain to financing of PG&E's capital program and not its capital structure.

NEG (Unregulated Affiliates) Debt

As of December 31, 2000, outstanding debt obligations of PG&E Corp. subsidiary companies that comprise NEG totaled $2.2 billion. Most of NEG's subsidiaries' credit agreements contain restrictive covenants that limit borrowings available to the subsidiaries and also limit or preclude distributions of earnings to the parent. The NEG subsidiary loan agreements also contain default provisions, which have the potential to accelerate NEG debt.

To obtain confirmation of PG&E GTN Holdings LLC's (GTN Holdings) credit rating by S&P and Moody's, NEG implemented a credit-enhancing technique known as "ring fencing" during the first week of January 2001. To construct a "ring fence," PG&E GTN Holdings established a single-purpose entity having an independent director and a special class of equity immediately above the subsidiaries to be protected. PG&E Corp., PG&E or any affiliate have not transferred any debt to GTN Holdings and there are no loan agreements with GTN Holdings. PG&E Corp. has transferred a number of its guarantees to provide credit support for the energy trading business of NEG's subsidiaries to GTN Holdings, thereby relieving PG&E Corp. of any obligations under these guarantees.

POWER PURCHASES AND CASH FLOWS (CHAPTER III)

- If PG&E's assumptions are used, we agree with PG&E's January 16, 2001 cash flow projection indicating that its cash balances become negative on February 1, 2001. However, PG&E's energy supply and demand forecasts and related cash flows included in the recent Emergency Rate Stabilization filings before the CPUC do not accurately portray near-term operating constraints and opportunities in responding to the current situation.

- Primarily because it does not have access to information on how the ISO computes its Out of Market power purchases, PG&E is unable to project its cash flow requirements accurately. In addition, PG&E has reduced its forecast of Qualified Facilities (QF) generation output for the first quarter of 2001, but has not adequately explained why it has done so.

- BWG projected PG&E's daily cash balances for the period through March 30, 2001 using a range of market clearing prices. The analysis indicated that with a market clearing price of $180 per MWh or lower PG&E would have a positive cash balance until March 2, 2001. If the California Department of Water Resources assumes responsibility for purchasing power to meet PG&E's daily loads, net of PG&E owned resources, using long term purchase power contracts, PG&E's cash position will remain positive until at least March 30, 2001.

- PG&E's bidding strategy resulted in a loss of its own generation to other buyers in the first ten days of December and has increased its ISO related costs.

CASH CONSERVATION ACTIVITIES (CHAPTER IV)

- In December 2000, PG&E prepared a cash conservation analysis that prioritized all cash expenditures into six tiers.

- During November and early December 2000, a group of PG&E financial personnel assessed cash conservation opportunities and categorized each into one of six tiers based upon its priority and expected effect upon PG&E and its customers.

- PG&E began implementing cash conservation efforts in December 2000.

- PG&E has procedures in place to monitor implementation of its cash conservation measures and to update its cash flow projections.

PG&E did not anticipate that it would be constrained in its borrowings and did not develop a cash conservation program until December 2000. Deferment or reduction of employee or management compensation represents one of the most immediate ways to achieve savings. While PG&E's cash conservation plan identified a hiring freeze and eliminated management merit increases, it did not specifically identify salary reductions, nor has it implemented these measures.

ACCOUNTING MECHANISMS TO TRACK STRANDED COST RECOVERY (TCBA and TRA) (CHAPTER V)

- Except for including the market value of its hydro facilities in its TCBA, PG&E has recorded entries to the TCBA and the TRA as required by the CPUC. Assembly Bill XI 6, enacted on January 18, 2001, indicates that PG&E's valuation assumption is no longer valid.

- Costs of purchasing generation are tracked in the TRA and revenues from generation are tracked in the TCBA. PG&E's under collection in the TRA is $6.7 billion as of December 31, 2000. Its net receipts from generation memorandum accounts are $1.5 billion as of December 31, 2000. If the CPUC were to require PG&E to net these amounts, PG&E's net purchase power liabilities would total $5.2 billion as of December 31, 2000.

PG&E maintains two balancing accounts used in the tracking of stranded cost recovery: the Transition Cost Balancing Account (TCBA) and the Transition Revenue Account (TRA). The TCBA allows PG&E to track the recovery of its current transition costs, including the accelerated recovery of plant balances, generation-related assets and obligations. PG&E's TCBA consists of a revenue section and three cost sections. The TRA matches total revenues from sales of electricity and related services against the amount of the unbundled revenue components and CPUC-approved obligations. This matching facilitates the determination of the residual revenues, which are transferred to the TCBA. The unbundled revenue components consist of transmission, distribution, nuclear decommissioning and public purpose programs. CPUC-approved obligations include Independent System Operator (ISO) charges, Power Exchange (PX) charges and Diablo Canyon-related Incremental Cost Incentive Pricing (ICIP) exclusions, as well as shareholder participation credits.

As of December 2000, PG&E reported an under-collected balance (excess costs) in the TRA of $6.7 billion, largely as a result of increased costs of power purchases from the PX. TCBA balances without including the valuation of PG&E's hydro plants and the associated generation memorandum account transfers result in a December 31, 2000 estimated under-collected balance, which would result in a continuation of the rate freeze. The generation memorandum account balance is $1.5 billion as of December 31, 2000. Decision 01-01-018 required PG&E to segregate this amount until the CPUC considers the proposal by The Utility Reform Network (TURN) to consolidate the TRA and TCBA account balances.

INTER-COMPANY CASH FLOWS (CHAPTER VI)

- From 1997 to 1999 PG&E provided PG&E Corp. $4.0 billion in the form of dividends paid and repurchases of stock. During the same period, PG&E Corp. invested $0.8 billion in its other subsidiaries, $2.7 billion to buy back its stock from the public and $1.5 billion to pay dividends to its shareholders.

- From 1997 to 2000, PG&E Corp. or other affiliates have not provided cash to PG&E.

Since 1997, PG&E has generated substantial amounts of cash from its operations and financing activities. In the first nine months of 2000, PG&E generated $1.8 billion in cash, of which $632 million was transferred to PG&E Corp. for common stock repurchases and dividends. Historically, cash has flowed in only one direction, from PG&E to PG&E Corp., and then to the unregulated affiliates.

AFFILIATE EARNINGS IN THE CALIFORNIA ENERGY MARKET (CHAPTER VII)

- NEG's 2000 earnings associated with affiliate activities in the California energy market were $117 million prior to income taxes and PG&E Corp. allocations.

PG&E's Gas Transmission (PG&E GT) operates extensively in the California energy market. PG&E GT owns and operates gas transmission pipelines and associated facilities that extend from the Canadian – U.S. border to the Oregon – California border. The amounts of the PG&E GT revenues and earnings before taxes and PG&E Corp. allocations attributable to the California energy market are estimated at $152.8 million and $66.9 million respectively for the year ended December 31, 2000. PG&E Energy Trading actively participates in the California gas and electric energy market. California business provided approximately 24 percent of PG&E Energy Trading's gross profits.

Principal PG&E Corp. affiliates include:

- Pacific Gas and Electric Company
- PG&E National Energy Group, Inc.
- PG&E Generating Company LLC
- PG&E Energy Trading Holdings LLC
- PG&E Gas Transmission

2000 FEDERAL INCOME TAX REFUND (CHAPTER VIII)

PG&E Corp. files its federal income taxes on a consolidated basis. Each affiliate prepares a tax return as if it were a standalone entity to determine its tax liability to PG&E Corp. If the affiliate has a tax liability, it reimburses PG&E Corp. for the amount of the liability. PG&E Corp. files the federal return and retains any savings that might result from the benefits of its consolidated report.

In the near future, PG&E Corp. expects to file its 2000 Federal income tax return that will claim a refund of $500 million to $1 billion. There is, however, no statutory or procedural requirement for the Internal Revenue Service (IRS) to pay a refund within a specified time period. PG&E Corp. has indicated to BWG that it has not yet determined if the tax refund attributable to the operational losses of PG&E will be remitted to the utility.

PG&E BACKGROUND

PG&E Corp. is a national energy-based holding company with 1999 gross revenues exceeding $20.8 billion and $29.7 billion in assets. PG&E Corp. is the parent of National Energy Group (NEG), and Pacific Gas and Electric Company (PG&E). PG&E serves 4.5 million electric customers and 3.7 million gas customers in northern and central California. PG&E had gross revenues of $9.2 billion in 1999. PG&E is regulated by the CPUC and the Federal Energy Regulatory Commission (FERC).

APPROACH

BWG conducted the review in four steps. Each of the steps is described below:

Step 1 - Interviewed Members of Management

BWG interviewed members of PG&E and PG&E Corp.'s financial management, PG&E's power supply management, and NEG management personnel.

Step 2 - Performed Technical Review

In this step, BWG performed its investigation and data analysis activities. Wherever possible, BWG sought to employ quantitative measures of performance. PG&E's practices were judged against sound, generally accepted business practices. We reviewed reports and documentation including:

- Reports to PG&E and PG&E Corp.'s boards of directors, and the CPUC.
- Documents and studies, both internally and externally generated, to determine areas of concern and degree of progress in addressing critical issues.
- Publicly issued assessments of PG&E's and PG&E Corp.'s financial condition by rating agencies.

Step 3 - Verified Facts

BWG reviewed the facts in this report with representatives of PG&E to ensure their accuracy. The findings and conclusions are solely those of BWG. The audit team also reviewed its findings and conclusions with the CPUC Project Director prior to completing this report to ascertain that BWG had addressed major issues.

Step 4 - Prepared and Issued Report

BWG then prepared and issued this report, which incorporates all of the areas selected for coverage by the CPUC and the results of our review.

AUDITING STANDARDS

BWG's review process ensures that work is factually based, that the observations and comments formed are supported by relevant data, that professional judgment, where applied, is differentiated from analytical results, and that the results of the review are easily traceable to specific consultant efforts.

The three parties involved in BWG's quality assurance process for this review were BWG consultants, the BWG Project Director, and the CPUC Project Director. Our approaches to project management and preparing an audit trail are essential components of BWG's quality assurance process. The BWG quality review process is designed to assure adherence to Generally Accepted Auditing Standards in accordance with "Government Auditing Standards" (1994 Revision) issued by the Comptroller General of the United States. No pertinent information was omitted from this report because it was deemed privileged or confidential.

The BWG Project Director was responsible for day-to-day monitoring of work, reviewing work products for compliance with project goals and objectives, and for anticipating and responding to problems or concerns. He ensured that the consultants were adequately supported, enforced administrative controls, assured consistency among approaches and methods, and scheduled work to ensure that the consultants were efficient in their efforts. He periodically reviewed the work in progress by attending interviews, assessing the processes used in analysis, testing conclusions, and checking the clarity and completeness of all written materials.

The CPUC Project Director reviewed the process and analysis used by the consultants, and reviewed the work products prepared by the review team. This review was useful in ensuring that the review team placed appropriate emphasis on issues important to the CPUC.

CHAPTER II

Credit and Default Relationships

A. CPUC OBJECTIVE

In defining the scope of this task, the CPUC requested that BWG prepare a narrative and an analysis of credit and default relationships of PG&E, PG&E Corp., and affiliate debt.

B. BACKGROUND

PG&E and its parent, PG&E Corp. have lost access to the commercial paper markets and are using their bank lines of credit to pay maturing commercial paper as it becomes due. PG&E has exhausted its borrowing capability under existing lines of credit and is on the verge of default under the provisions of many of its loan agreements. PG&E cash flow projections show that available cash balances will be exhausted about February 2, 2001. Under its short-term credit agreements, PG&E is required to make payments when due and will be in default if accounts payable arising in the ordinary course of business of $100 million or more become overdue. PG&E Corp.'s loan agreements contain default provisions that are similar to those of PG&E, regarding the payment of debts when due. In addition, although the opposite is not true, under PG&E Corp.'s credit agreements default by PG&E constitutes an event of default for PG&E Corp.

A similar cash flow analysis for PG&E Corp. shows that it will have exhausted its borrowing ability under its credit facilities by March 31, 2001 as its commercial paper becomes due. As of March 31, 2001, available investment balances are projected to be $340 million. Projections show that $3.2 million and $4.9 million in cash is required to support PG&E Corp. operations in February and March 2001, respectively. Accordingly, PG&E Corp. has the cash it needs to support its operations for several months to come.

Affiliated companies in the National Energy Group (NEG) have separate loan agreements. In January 2001, NEG completed an intra-Corporate reorganization, which moved PG&E Corp.'s investments in PG&E Gas Transmission (PGT) and PG&E Energy Trading (ET) into a newly formed limited liability Corporation, GTN Holdings, LLC This transaction moved these PG&E Corp. subsidiaries' assets into a bankruptcy remote entity and relieved PG&E Corp. of its guarantees of the NEG subsidiaries debt. In addition, the reorganization negated the cross-default provisions in some NEG loan agreements, whereby default by either PG&E or PG&E Corp. would have triggered an event of default for NEG.

On January 16, 2001, Standard & Poor's (S&P) reduced the long-term corporate credit ratings of PG&E Corp. and PG&E to CC from BBB-. S&P stated that the downgrades reflected the heightened probability of PG&E’s imminent insolvency and the resulting negative financial implications for affiliated companies. On January 17, 2001, Moody’s reduced PG&E’s senior unsecured debt rating to Caa2 from Baa3 and reduced its short term rating for commercial paper to Not Prime from Prime-3. Moody’s also reduced PG&E Corp.’s issuer rating to Caa3 from Baa3 and its short term commercial paper rating to Not Prime from Prime-3.

S&P’s minimum investment grade rating is BBB-. Moody’s minimum investment grade rating is Baa3. Thus, the ratings downgrade by both S&P and Moody’s resulted in below minimum investment grade ratings for PG&E Corp. and PG&E. Ratings below investment grade constitute an event of default under the PG&E Corp. bank lines of credit agreements and under one of PG&E’s bank line agreements. Beginning January 16, 2001, the banks have refused to allow drawdowns under the PG&E and PG&E Corp. credit agreements and the companies are not paying maturing commercial paper as it becomes due. These events significantly affect PG&E and PG&E Corp.’s credit standing and add to the uncertainty of the California energy crisis. These events may trigger other actions by the companies and various lenders that bear directly upon the information provided in this report.

On December 28, 2000, NEG filed an application with FERC for authorization to alter the upstream ownership of the subsidiaries. The application was approved by FERC on January 12, 2001. According to S&P’s Credit Wire, the reorganization was intended to “ring-fence” the subsidiaries from the possible bankruptcy or credit downgrade of PG&E Corp. or PG&E. Under this reorganization, a new entity NEG LLC was formed, which is a limited liability company that is a wholly-owned subsidiary of PG&E Corp. NEG LLC has two members. The Class A member is PG&E Corp. The Class B member is an independent corporate services company. The Class A member is entitled to all profits and losses of the NEG LLC. The Class B member is not entitled to any economic interest in NEG LLC and will not vote on any matters concerning NEG LLC.

C. EVALUATIVE CRITERIA

BWG used the following criteria to analyze the credit and default relationships of PG&E, PG&E Corp. and NEG:

- Has PG&E made accurate representations of its borrowing capability, credit condition, and potential events of default?

- Has PG&E obtained the credit it requires, and has it entered into new and amended loan agreements? What are the conditions of the new terms?

- What level of financial assistance and support has PG&E Corp. provided PG&E?

- What steps has PG&E Corp. taken to mitigate the effects of potential default by PG&E?

D. WORK TASKS

During the period from December 26, 2000 to January 19, 2001, BWG performed the following tasks:

- Reviewed PG&E Corp. and PG&E financial statements as of December 31, 1999 and as of September 30, 2000 and developed a listing of all long-term and short-term debt.

- Verified the listing of long-term and short-term debt with PG&E, PG&E Corp. and NEG representatives and obtained loan agreements relating to all significant borrowings outstanding as of December 31, 2000.

- Prepared exhibits summarizing the provisions of the loan agreements.

- Prepared exhibits summarizing dollar amounts of debt outstanding as of December 31, 2000, and payments of principal and interest required to be made in the year 2001.

- Reviewed CPUC Order D. 96-11-017 relating to the formation of PG&E Corp. having to do with permitted inter-company transactions.

- Analyzed default and cross default provisions of loan agreements.

E. FINDINGS AND CONCLUSIONS

1. As of December 31, 2000, PG&E's outstanding debt obligations totaled $9.5 billion, which would require principal and interest payments of $3.2 billion in 2001.

   - **Exhibit II-I** provides PG&E's original amount, and the amount due of all PG&E debt as of December 31, 2000. It also provides the principal and interest payments due on that debt in 2001.

Exhibit II-1

PG&E Debt Obligations As of December 31, 2000
($ million)

Debt Description	Original Amount	12/31/00 Balance	2001 Principal and Interest Payments
Floating rate notes	$1,240	$1,240	$1,324
Commercial paper backed by bank lines of credit	1,232	1,232	1,232
First mortgage bonds	3,925	3,462	335
Unsecured medium term notes	305	305	155
Pollution control bonds	1,683	1,612	75
Senior notes	680	680	50
Bank lines of credit	614	614	40
Quarterly Income Preferred Securities (QUIPS)	300	300	23
San Joaquin Valley (SJV) bond	12	12	2
Department of Water Resources (DWR)	8	8	2
Totals	**$10,009**	**$9,465**	**$3,238**

Source: Data request JDH-1.3 and BWG Analysis.

- Commercial paper is sold at a discount and the nominal amounts due include principal and interest. In 2001, PG&E's outstanding commercial paper matures as follows: $796 million in January, $294 million in February, and $142 million in March. Under current conditions, there is no market for PG&E's commercial paper and the lines of credit previously in place to back the commercial paper were being drawn upon for repayment of the commercial paper.

- PG&E, through its wholly owned subsidiary, PG&E Capital I (Trust), has 12 million shares of 7.90 percent quarterly income preferred securities (QUIPS), with an aggregate liquidation value of $300 million outstanding. Concurrent with the issuance of the QUIPS, the Trust received $9 million from PG&E for its equity capital and used the $309 million to purchase subordinated debentures issued by PG&E with a face value of $309 million, an interest rate of 7.90 percent, and a maturity date of 2025. The subordinated debentures are the only assets of the Trust. Proceeds from the sale of the subordinated debentures were used to redeem and repurchase higher-cost preferred stock. Upon liquidation or dissolution of PG&E, holders of the QUIPS would be entitled to the liquidation preference of $25 per share plus all accrued and unpaid dividends thereon to the date payment.

- Not included in Exhibit II-I are about $2 billion in Rate Reduction Bonds (RRBs) outstanding as of December 31, 2000, issued by PG&E Funding LLC (PG&E Funding) in December 1997. PG&E Funding is a special purpose entity (SPE) wholly owned by PG&E. The RRBs were issued to the California Infrastructure and Economic Development Bank Special Purpose Trust PG&E-1, a SPE. The proceeds of the RRBs were used by the SPE to purchase from PG&E the right, known as "transition property," to be paid a specified amount from a non-bypassable tariff levied on residential and small commercial customers which was authorized by the CPUC pursuant to state legislation. While the SPE is consolidated with PG&E for financial reporting purposes, the SPE is legally separate from PG&E. The assets of the SPE are not available to creditors of PG&E, and the transition property is not legally an asset of PG&E.

2. PG&E has exhausted its borrowing capability under existing lines of credit and is on the verge of default under the provisions of many of its loan agreements.

    - As indicated in **Exhibit II-2**, which summarizes PG&E's loan agreements, non-payment of principal and interest when due constitutes an event of default under all of the loan agreements.

    - An event of default occurs under the short-term loan agreements (bank lines of credit), upon default by PG&E or any significant subsidiary as defined by the Securities and Exchange Commission (SEC) in the payment of other debt of $100 million or more, including any notice of default and failure to cure.

    - Under the unsecured medium term note indenture and the bank lines of credit, an event of default occurs upon the commencement of voluntary bankruptcy proceedings or upon issuance of a court order in an involuntary bankruptcy proceeding.

- Under the first amended and restated credit agreement dated December 1, 2000, an event of default occurs upon assignment of senior unsecured, non-credit enhanced long-term debt ratings of less than Baa3 or BBB- by Moody's Investors Service (Moody's) or S&P.

- Except for the first mortgage bonds, an event of default occurs in the event of default under other agreements. Under the unsecured medium term notes agreement, events or conditions resulting in the acceleration of the maturity of other indebtedness of more than $10 million is also an event of default.

- A continuing cash shortage affecting the maintenance of property could trigger default under the first mortgage bond and unsecured medium term notes agreements. These agreements require that all properties be maintained in good repair and working condition.

Exhibit II-2

PG&E Loan Agreement Summary

Debt Description, Date and Term	Agents and Debt Holder	Key Amendments	Selected Default Provisions	Selected Covenants and Provisions
First mortgage bonds. Secured by all real properties and substantially all personal properties. Original indenture (December 1, 1920) Fourteenth and most recent supplemental indenture (December 1, 1988)	California trustee: Bank of New York Western Trust Company New York trustee has resigned. Debt is publicly held.	Bonded indebtedness of $160 million designated in the original indenture was increased in a series of supplemental indentures to $10 billion in the fourteenth supplemental indenture.	Non-payment of principal and interest or default in the observance or performance of any other covenant or condition upon failure to comply with any covenant within 50 days of receiving notice of such failure, 25 percent of the bondholders can serve notice of default.	Additional bonds may be issued only if "aggregate net earnings" are at least equal to 1.75 times annual interest charges on bonded indebtedness including bonds about to be issued. Pay principal and interest in accordance with terms of indenture. Maintain all properties in good working order and condition.
Unsecured medium term notes. Indenture (September 1, 1987) First supplemental indenture (June 1, 1990) Second supplemental indenture (November 1, 2000)	Trustee: The Bank of New York Debt is publicly held.	First supplemental indenture (June 1, 1990) provides for issuance of book-entry securities. Second supplemental indenture (November 1, 2000) provides for issuance of two new separate series of notes. Floating rate notes due 2001. 7.375 percent senior notes due 2005.	Non-payment of principal, interest or sinking fund payments. Breach of covenants. Events or conditions resulting in the acceleration of the maturity of other indebtedness of more than $10 million. Commencement of voluntary bankruptcy proceedings or court order in involuntary bankruptcy proceeding.	All properties must be maintained in good condition. All lawful claims for labor, materials and supplies must be paid if they otherwise might by law become a lien upon the property of PG&E. Floating rate notes issued November 1, 2000 bear interest at the London inter-bank overnight rate (LIBOR) three-month rate plus an adjustment of up to 0.875 percent if ratings on senior unsecured long-term debt fall to Ba1 (Moody's) or BB+ (Standard & Poor's). With ratings of Baa3 (Moody's) or BBB- (S&P) the adjustment is 0.375 percent. Interest rates are adjusted quarterly.
Pollution control bonds secured primarily by irrevocable letters of credit.	Issued to the public by the California Pollution Control Financing Authority			Secured by $1.3 billion letter of credit.

Exhibit II-2
(continued)
PG&E Loan Agreement Summary

Debt Description, Date and Term	Agents and Debt Holder	Key Amendments	Selected Default Provisions	Selected Covenants and Provisions
San Joaquin Valley (SJV) transmission capacity revenue bonds secured by project revenues. Revenue bonds issued by SJV November 1, 1991. Liability assumed by PG&E under transmission agreement dated February 12, 1998	Trustee: Bank of America Publicly held.		Prohibition of liens against trust estate consisting of net revenues from transmission project.	Non-payment of principal and interest when due.
DWR comprehensive agreement. April 22, 1982	Department of Water Resources	None	None	Agreement provides for transmission service and for repayment by PG&E of funds advanced by DWR for construction.
Floating rate notes. Same as unsecured medium term notes. November 1, 2000			Same as unsecured medium term notes.	Same as unsecured medium term notes plus prohibition on issuing secured debt prior to May 1, 2002 without making effective provision for securing these notes. Utility may issue secured debt without securing these notes so long as the utilities aggregate secured debt outstanding does not exceed 10 percent of “consolidated net tangible assets” of the utility. Prohibition on liens on any assets to secure any debt or other obligations except existing liens, the lien of the first mortgage bond indenture, liens on transition property, and liens securing other debt in an aggregate amount not to exceed ten percent of net tangible assets.

Exhibit II-2
(continued)
PG&E Loan Agreement Summary

Debt Description, Date and Term	Agents and Debt Holder	Key Amendments	Selected Default Provisions	Selected Covenants and Provisions
Senior notes. Same as unsecured medium term notes. November 1,2000			Same as unsecured medium term notes.	Same as unsecured medium term notes plus prohibition on issuing secured debt prior to May 1, 2002 without making effective provision for securing these notes. Prohibition on liens on any assets to secure any debt or other obligations except existing liens, the lien of the first mortgage bond indenture, liens on transition property, and liens securing other debt in an aggregate amount not to exceed ten percent of net tangible assets.
$1 billion global revolving credit facility. Dated: November 29, 1993 Amended: October 1, 1994 November 30, 1995 November 22, 1996 Originally a four-year term with options for annual one-year extensions. November 22, 1996 amendment extends term to November 29, 2001 (Replaced by December 1, 1997, agreement discussed on Pg. II-11).	Administrative Agent: Bank of America Several Syndication Co-Agents	Amendments changed compensation amounts payable to banks. Compensation amounts are tied to S&P and Moody's rating levels applicable to first mortgage bonds.	Interest rate increases in the event of non-payment of principal when due, including an acceleration. Non-payment of principal and interest when due Default by PG&E or any significant subsidiary in the payment of other debt of $100 million or more, including any notice of default and failure to cure. Default in the performance of certain covenants of PG&E. Application for or consent to the appointment of a receiver or petition for bankruptcy by PG&E or any significant subsidiary.	Total equity, including preferred stock shall not be less than $5.5 billion. Ratio of debt (reduced by short-term debt and regulatory balancing accounts receivable) shall not exceed 65 percent of total capitalization. Prohibition on liens upon any assets to secure any debt or other obligations except existing liens, the lien of the first mortgage bond indenture, liens on transition property, and liens securing other debt in an aggregate amount not exceeding $100 million.

Exhibit II-2
(continued)
PG&E Loan Agreement Summary

Debt Description, Date and Term	Agents and Debt Holder	Key Amendments	Selected Default Provisions	Selected Covenants and Provisions
First amended and restated credit agreement Dated December 1, 2000	Administrative Agent: Bank of America Several Syndication Co-Agents.	Original credit agreement dated October 18, 2000 Amended December 1, 2000 The October 18, 2000 agreement provided for a $400 million 364-day facility and a $600 million 366 day facility to fit the unused short and long term CPUC borrowing authorizations. After the CPUC approved $1.4 billion in short-term borrowing, the December 20, 2000 amendment canceled the 366-day facility and transferred that amount to the 364-day facility making $1 billion available under the new agreement. A further amendment reduced the $1 billion available to $850 million because not enough banks subscribed to the new facility and PG&E had previously agreed to reduce Bank of America's exposure.	Failure to pay principal or interest on loans under this agreement. Default by PG&E or any significant subsidiary in the payment of principal or interest on any other debt. Default in any of its obligations to provide required notices and meet other loan covenants. Application for or consent to the appointment of a receiver or petition for bankruptcy by PG&E or any significant subsidiary. Assignment of senior unsecured, non-credit enhanced long-term debt ratings of less than Baa3 or BBB-, by Moody's or S&P, respectively.	Compensation amounts relating to facility fee, utilization fee and interest rates are tied to applicable rating levels of S&P and Moody's and increase as ratings decline. PG&E must maintain at all times minimum senior unsecured long term debt ratings, equal to or better than acceptable ratings of BBB in the case of S&P and Baa2 in the case of Moody's.

Exhibit II-2
(continued)
PG&E Loan Agreement Summary

Debt Description, Date and Term	Agents and Debt Holder	Key Amendments	Selected Default Provisions	Selected Covenants and Provisions
$1 billion amended and restated credit agreement December 1, 1997 Five year term continuing through November 29, 2002.	Administrative Agent: Bank of America Several Syndication Co-Agents	Amendment No. 1 dated November 29, 1998, removes as an event of default a default by PG&E Corp..	Interest rate increases in the event of non-payment of principal when due, including an acceleration. Non-payment of principal and interest when due. Default by PG&E or any significant subsidiary in the payment of other debt of $100 million or more, including any notice of default and failure to cure. Default in the performance of certain covenants of PG&E. Application for or consent to the appointment of a receiver or petition for bankruptcy by PG&E or any significant subsidiary.	Compensation amounts relating to facility fee, utilization fee and interest rates are tied to applicable rating levels of S&P and Moody's and increase as ratings decline. Prohibition on liens upon any assets to secure any debt or other obligations except existing liens, the lien of the first mortgage bond indenture, liens on transition property, and liens securing other debt in an aggregate amount not exceeding $1 billion.
Quarterly Income Preferred Securities (QUIPS) Indenture dated as of November 28, 1995.	Trustee: First National Bank of Chicago Issued by PG&E Capital I and guaranteed by PG&E.	Security interest is subordinate to senior debt which includes almost all other debt	Non-payment of principal and interest when due.	Right to name members of Board of Directors.

Source: PG&E loan agreements and BWG analysis.

3. While PG&E has potential borrowing capability under its first mortgage bonds, current conditions preclude obtaining funds easily.

   - The indenture creates a lien on all real and personal property which PG&E now owns or subsequently acquires. Because this is a general lien on all utility property, plant and equipment, specific assets are not identified in the agreement.

   - The first $4.3 billion of the indenture is used and $2.7 billion is available if specified conditions are met. As of September 30, 2000, the recorded cost ($23.4 billion) less depreciation ($10.6 billion) of PG&E utility property, plant and equipment was $12.8 billion.

   - The indenture contains an additional bonds test which provides that additional bonds may be issued only if "aggregate net earning" are at least equal to 1.75 times annual interest charges on bonded indebtedness including bonds about to be issued. The manner in which PG&E finally accounts for amounts recorded in the TRA as of December 31, 2000, will affect whether or not this test can be met.

   - Under a complex formula, the indenture limits borrowings to an amount equal to 75 percent of unreimbursed capital expenditures by PG&E. As of December 31, 2000, this calculation places a limit on additional borrowings of $2.7 billion.

4. Certain provisions of other loan agreements and the CPUC order establishing an approved PG&E capital structure also limit borrowings.

   - The revolving credit agreements contain a prohibition on liens other than liens under the first mortgage bond indenture.

   - The credit agreement dated December 1, 2000 requires that total equity, including preferred stock shall not be less than $5.5 billion. In addition, this agreement specifies a ratio of debt (reduced by short-term debt and regulatory balancing accounts receivable) of not more than 65 percent of total capitalization.

   - CPUC Order D. 00-06-040 dated June 8, 2000 establishes a target capitalization ratio consisting of 46.2 percent long-term debt, 5.8 percent preferred stock, and 48.0 percent common equity.

5. Although the RRBs do not represent an obligation of PG&E, the State of California, the Infrastructure Bank, or any other governmental agency, occurrence of certain events of default under the servicing agreement cause the acceleration of the payment of collections.

   - The rating agency condition requires ratings of the RRBs at the time of issuance to be in one of the four highest rating categories.

   - Events of servicer defaults include:

     – Non-payment of collections when due

     – Failure of the servicer to fulfill its obligations under the servicing agreement

     – Any incorrect representation by PG&E at the time of the issuance of the RRBs that has a material adverse effect

     – Certain events of insolvency, readjustment of debt, marshalling of assets and liabilities, or similar proceedings with respect to the servicer or the seller and certain actions by the servicer or the seller indicating its insolvency, reorganization pursuant to bankruptcy proceedings, or inability to pay its obligations.

   - Events of default under the servicing agreement cause the acceleration of the payment of collections of the transition property by PG&E to the Trustee. Payments normally made monthly 20 days following the end of the month become due daily within two days of collection.

6. Although PG&E's credit agreements do not contain provisions that require periodic amendments, they are originally written for a fixed term and are often renewed or extended through amendments.

   - The $1 billion global revolving credit facility dated November 29, 1993 was originally for a four-year term. This facility was amended three times to extend its term. This agreement was replaced by the first amended and restated credit agreement dated December 1, 2000.

   - The amended and restated credit agreement dated December 1, 1997 provides for a $1 billion line of credit with Bank of America as the lead bank. This agreement was amended once. As originally written, this credit agreement is for a term continuing through November 29, 2002, with the provision that PG&E may annually request an extension of the facility for additional successive one-year periods. The November 29, 1998 amendment to the agreement changed the cross default provisions by eliminating a default by PG&E Corp. as an event of default for PG&E.

- The floating rate notes and senior notes were issued on November 1, 2000 under a second supplemental indenture to the unsecured medium term note indenture.

- The first amended and restated credit agreement dated December 1, 2000 replaces a credit agreement dated October 18, 2000. This agreement was originally designed as a $1.0 billion credit facility. However, following syndication, participating banks agreed to extend approximately $850 million in credit.

- PG&E indicates that the acceptable credit rating default provision was added to the December 1, 2000 loan agreement in anticipation of the transfer of PG&E's hydroelectric facilities to a new affiliate. This and related transactions involving the Transition Revenue Account (TRA) would reduce PG&E equity to a point that would constitute an event of default under the terms originally proposed for the agreement.

- A summary of terms and conditions relating to the aforementioned transaction prepared by Bank of America dated September 29, 2000 indicates that the requirement for the maintenance of a ratio of total funded debt to total capitalization of not greater than 65 percent was removed and replaced by the threshold ratings provision. In addition, the term sheet indicates that the restriction on the sale of assets clause in the agreement would include an exception for the transfer of the hydroelectric assets by PG&E to an affiliate.

7. PG&E Corp. has both long-term debt and short-term debt outstanding under its loan agreements with banks totaling $1.0 billion.

    - The bank lines of credit provide for unsecured borrowings of $1 billion as of December 31, 2000 and are used to back the issuance of commercial paper and for working capital. The detail of amounts outstanding as of December 31, 2000 are shown in **Exhibit II-3**.

Exhibit II-3

PG&E Corp. Debt Obligations as of December 31, 2000
($ million)

Debt Description	**Original Amount**	**12/31/00 Balance**	**2001 Principal and Interest Payments**
$500 million credit agreement (8/26/97)	$500	$185	$12
364-day credit agreement (11/24/00)	436		
Commercial paper backed by bank lines of credit)		746	746
Totals	**$936**	**$931**	**$758**

Source: Data request JDH-1.3 and BWG Analysis.

- Commercial paper is sold at a discount and the nominal amounts due include principal and interest. In 2001, PG&E Corp.'s commercial paper matures as follows: $510 million in January, $188 million in February, and $47 million in March. Under current conditions, there is no market for PG&E Corp. commercial paper and the lines of credit previously in place to back the commercial paper are being drawn upon for repayment.

8. Based on its cash forecasts, PG&E Corp. will exhaust its borrowing ability under its credit facilities by March 31, 2001 as its commercial paper becomes due.

- As of March 31, 2001, PG&E Corp. projects its available investment balances to be $340 million.

- Projections show that $3.2 million and $4.9 million in cash is required to support PG&E Corp. operations in February and March 2001, respectively. Accordingly, absent an acceleration of PG&E Corp. short-term debt, PG&E Corp. has the cash it needs to support its operations for an extended period.

9. Default by PG&E under its loan agreements would constitute an event of default for PG&E Corp. under its agreements.

- As indicated in **Exhibit II-4,** a PG&E Corp. loan agreement summary, default by PG&E Corp. or any significant subsidiary in the payment when due

Exhibit II-4

PG&E Corp. Loan Agreement Summary

Debt Description, Date and Term	Agents and Debt Holder	Key Amendments	Selected Default Provisions	Selected Covenants and Provisions
$500 Million Credit Agreement. Dated August 26, 1997	Administrative Agent: Bank of America Other financial institutions.	Amended and restated five-year credit agreement dated December 1, 1997. Term extended by one year through November 29, 2002.	Non-payment of principal or interest Default by PG&E Corp. or any significant subsidiary in the payment when due of any principal or interest on any other debt the principal of which aggregates $100 million or more. Application by PG&E Corp. or any significant subsidiary or consent to the appointment of a receiver or commencement of a voluntary case under the bankruptcy code. PG&E Corp. ceases for any reason to own at least 80 percent of each of PG&E, PG&E Gas Transmission, and PG&E Enterprises. PG&E Corp.'s unsecured long-term debt ceases to be rated at least Baa3 (Moody') or BBB- (S&P) PG&E Corp.'s guarantee ceases to be in full force or effect.	Defines acceptable rating as equal to or better than Baa2 (Moody's) and BBB (S&P). Facility fee and interest rates are tied to applicable rating levels of S&P and Moody's and increase as ratings decline. Obligors are defined in introductory clause of agreement as those listed in a schedule attached. At the date of the original agreement no obligors were listed on this schedule. PG&E Corp. unconditionally and irrevocably guarantees full and prompt payment of the guaranteed obligation of each obligor.
$500 million 364-day credit agreement. Dated August 26, 1997 (replaced by the November 24, 2000 agreement described below)	Administrative Agent: Bank of America Other financial institutions.	Renewed Annually: December 1, 1997 November 29, 1998 November 26, 1999 Amendments extend term to date of ensuing amendment.	Default provisions are the same as those contained in the five-year $500 million credit agreement.	Conforms to the five-year $500 million credit agreement. Covenants and other provisions are the same as for the five-year $500 million credit agreement. No obligors are listed on the attached schedule.

Exhibit II-4
(continued)
PG&E Corp. Loan Agreement Summary

Debt Description, Date and Term	Agents and Debt Holder	Key Amendments	Selected Default Provisions	Selected Covenants and Provisions
364-day credit agreement. Dated November 24, 2000	Administrative Agent: Bank of America Several Syndication and Documentation Agents	Replaces the August 26, 1997 364-day credit agreement.	Non-payment of principal or interest. Default by PG&E Corp. or any significant subsidiary in the payment when due of any principal or interest on any other debt the principal of which aggregates $100 million or more. Application by PG&E Corp. or any significant subsidiary or consent to the appointment of a receiver or commencement of a voluntary case under the bankruptcy code. PG&E Corp. ceases for any reason to own at least 80 percent of each of PG&E, PG&E Gas Transmission, and PG&E Generating Company. PG&E Corp.'s unsecured long-term debt ceases to be rated at least Baa3 (Moody') or BBB- (S&P).	Defines acceptable rating as equal to or better than Baa2 (Moody's) and BBB (S&P). Facility fee, utilization fee and interest rates are tied to applicable rating levels of S&P and Moody's and increase as ratings decline.

Source: PG&E Corp.. loan agreements and BWG analysis.

of any principal or interest on any other debt the principal of which aggregates $100 million or more is an event of default under all of the loan agreements.

- Application by PG&E Corp. or any significant subsidiary or consent to the appointment of a receiver or commencement of a voluntary case under the bankruptcy code is an event of default under the PG&E Corp. credit agreements.

- Non-payment of principal and interest when due by PG&E Corp. also constitutes an event of default.

10. The PG&E Corp. credit agreement dated August 26, 1997 has a rating agency trigger as an event of default.

    - The agreement requires notice of any change in rating or an announcement that the rating is “under review” or on a “credit watch list”.

    - The agreement itemizes events of default which includes PG&E Corp.’s unsecured long-term debt ceasing at any time to be rated at least Baa3 by Moody’s or at least BBB- by S&P.

11. Although rating notice provisions are included in PG&E loan agreements from as far back as November 29, 1993, a ratings threshold as an event of default did not appear until 2000.

    - The November 29, 1993 credit agreement and the December 1, 1997 loan agreement with Bank of America do not include the rating agency triggers as an event of default.

    - The first amendment agreement dated December 1, 2000 to the December 1, 1997 loan agreement includes the rating agency default trigger. Acceptable ratings are defined as investment grade and above. Failure to comply with the covenant relating to acceptable ratings becomes an event of default.

12. Provisions in the CPUC order approving the formation of the PG&E Corp. holding company require that PG&E Corp.’s Board of Directors give first priority to PG&E’s capital requirements to meet its obligation to serve.

    - CPUC D. 96-11-017 (Holding Company Decision) dated November 6, 1996 grants authority for the formation of the PG&E Corp..

    - Ordering Paragraph 14 provides that PG&E shall maintain a balanced capital structure consistent with that determined to be reasonable by the CPUC in its most recent decision on PG&E’s capital structure. PG&E’s equity shall be retained such that the CPUC’s adopted capital structure shall be maintained on average over the period the capital structure is in effect for rate-making purposes. The Holding Company Decision also provides, however, that PG&E shall file an application for a waiver, on a case-by-case basis and in a timely manner, of this condition if an adverse financial event at PG&E reduces PG&E's equity ratio by one percent or more.

- Ordering Paragraph 15 states that the dividend policy of PG&E shall continue to be established by PG&E's Board of Directors as though PG&E were a comparable stand-alone PG&E company.

- Ordering Paragraph 16 states that PG&E shall not guarantee the notes, debentures, debt obligations, or other securities of PG&E Corp. or any of its subsidiaries without first obtaining the written consent of the CPUC.

- Ordering Paragraph 17 states that the capital requirements of PG&E, as determined to be necessary to meet its obligation to serve, shall be given first priority by the Board of Directors of PG&E Corp. and PG&E.

- CPUC Order D. 00-06-040 dated June 8, 2000 provides the most recent authorization for PG&E's rates of return and establishes a target capitalization ratio consisting of 46.2 percent long-term debt, 5.8 percent preferred stock, and 48.0 percent common equity.

13. PG&E Corp.'s Chief Financial Officer advised BWG that PG&E Corp. interprets this requirement to pertain to financing of PG&E's capital program and not its capital structure.

    - In the proceedings referred to in PG&E's orders, the Division of Ratepayer Advocates (DRA) explains that to the extent that PG&E affiliates compete with PG&E for scarce capital, this condition is necessary to protect ratepayers by requiring the directors of PG&E and PG&E Corp. to place top priority on PG&E's obligation to serve its customers.

    - In this context, Ordering Paragraph 17 means capital investment by the parent in PG&E, not investment by PG&E in capital assets.

14. As of December 31, 2000, outstanding debt obligations of companies which comprise PG&E National Energy Group (NEG) totaled $2.2 billion as shown in **Exhibit II-5**:

Exhibit II-5

NEG Debt Obligations as of December 31, 2000
($ million)

Debt Description	**Original Amount**	**12/31/00 Balance**
Revolving credit facilities (five agreements)	$1,350	$1,180
PG&E GT:		
Senior notes	250	250
Senior debentures	150	150
Medium term notes	39	39
Capital lease obligation	16	16
PG&E GEN.:		
Senior debentures		250
Term loans		424
Other		7
Total		**$2,316**

Note: Does not include non-recourse debt at the project level.
Source: Data request JDH 6 and BWG analysis.

- The revolving credit facilities support commercial paper and Eurodollar borrowing arrangements. In addition, certain letters of credit held by NEG reduce the available outstanding facility commitments. At December 31, 2000, approximately $36 million letters of credit were outstanding under these facilities, meaning that approximately $134 million in funding was available as indicated in **Exhibit II-6**.

Exhibit II-6

Available Funding from NEG Revolving Credit Facilities for NEG Activities
($ million)

Affiliate	**Amount**
PG&E Generating Company	$45
US Gen New England	25
PG&E Gas Transmission, NW	64
Total	**$134**

Source: BWG analysis.

- According to S&P, PG&E Gas Transmission (GTN) has a capital structure with about 64 percent debt leverage. Internal cash generation is expected to be adequate to fund projected capital spending of less than $400 million from 2001 to 2004. Although interest coverage is expected to exceed 3.3 times over the next five years, additional borrowing capability is likely to be limited.

- A summary of the NEG credit agreements is provided in **Exhibit II-7**.

15. Although each of the NEG subsidiaries' makes some of its own credit arrangements, most of the credit agreements contain restrictive provisions that limit the amount of borrowings available to the subsidiaries and also limit or preclude distributions of earnings to the parent.

    - The $1.1 billion PG&E Generating Company LLC credit agreement requires that debt not exceed 55 percent of total capitalization.

    - The PG&E Gas Transmission Northwest 364-day credit agreement and its indenture contain limitations on the issuance of debt secured by mortgages.

    - The Hermiston Generating Company agreement and the US Generating Company loan agreements provide that distributions to the parent may not be made until specified conditions are met. Currently, no amounts are available for distribution. Proceeds on hand are being used for internal working capital.

16. The NEG subsidiary loan agreements also contain default provisions which have the potential to accelerate NEG debt.

    - Non-payment of debt in specified amounts is an event of default in all of the agreements.

    - Commencement of voluntary or involuntary bankruptcy proceedings is an event of default in all of the agreements.

17. To obtain confirmation of PG&E GTN's credit rating by S&P and Moody's, during the first week in January 2001, PG&E NEG implemented a credit-enhancing technique known as "ring-fencing".

    - Because of PG&E Corp.'s pending credit rating downgrade, GTN was threatened with a substantial downgrade of its investment grade credit rating.

    - The key step in constructing a ring-fence is the establishment, immediately above the subsidiary to be protected, a single-purpose entity having an independent director and a special class of equity. Both the independent director and the holder of the special equity are vested with the power to veto any action to file for voluntary bankruptcy protection, and the independent director is required to approve certain other matters.

Exhibit II-7

NEG Loan Agreement Summary

Debt Description	PG&E Affiliate	Key Amendments	Selected Default Provisions	Selected Loan Covenants and Provisions
$1.1 billion credit agreement with $550 million in a five-year capital and revolving credit facility and $550 million in a 364-day revolving credit facility. Dated September 1, 1998 Five-year term ad 364-day term (next maturity is August 2001).	U.S. Generating Co., LLC		Default in the observance or performance of any covenant in the agreement. Non-payment of principal or interest due on debt in excess of $40 million. Commencement of voluntary bankruptcy proceedings or court order in involuntary bankruptcy proceeding.	The ratio of cash flow available for fixed charges to fixed charges not to be less than 2.00 to 1.00. Funded indebtedness may not exceed 55 percent of total capitalization. Borrower will not make any distributions, other than distributions permitted under another credit agreement. Limitations on disposition of assets.
$575 million credit agreement. Dated September 1, 1998 Five-year term.	USGen New England, Inc.	$475 million short-term portion cancelled in Fall 1998 upon Bear Swamp transaction.	Default in the observance or performance of any covenant in the agreement. Non-payment of principal or interest due on debt in excess of $25 million. Commencement of voluntary bankruptcy proceedings or court order in involuntary bankruptcy proceeding.	Ratio of cash flow available for fixed charges to fixed charges not to be less than 2.00 to 1.00. Funded indebtedness may not exceed 50 percent of total capitalization. Limitations on disposition of assets.
Credit agreement for 474 MW natural gas-fired cogeneration facility in Hermiston, Oregon for at least $1 million. Dated November 15, 1994	Hermiston Generating Company, L.P.		Default in the payment of any obligation exceeding $250 thousand. Non-payment of principal or interest due on debt in excess of $50 million.	Debt ratio not to exceed 70 percent. Borrower will not make or declare any distributions until specified conditions are met.
$50 million 364-day Credit Agreement. Dated May 24, 1999	PG&E Gas Transmission	Term advances omitted	Non-payment of principal or interest due on debt in excess of $50 million. Default in the event of voluntary or involuntary bankruptcy.	Debt ratio not to exceed 70 percent. Prohibition on the disposition of assets. Limitation on debt secured by mortgages.

Exhibit II-7
(continued)
NEG Loan Agreement Summary

Debt Description	PG&E Affiliate	Key Amendments	Selected Default Provisions	Selected Loan Covenants and Provisions
Indenture relating to senior debt securities. Dated May 22, 1995	Pacific Gas Transmission Company		Default in the payment of debt in excess of 5 percent of net tangible assets. Default in the performance or observance of any other covenant or agreement Default in the event of voluntary or involuntary bankruptcy.	Prohibition on the issuance of debt secured by any mortgage, security interest, or lien.

- The rating process required adoption of a dividend standard based on GTN's financial condition and the independent director's vote on GTN dividends.

- PG&E Corp., PG&E or any affiliates of NEG have not transferred any debt to GTN and there are no loan agreements related to this structure. However, PG&E Corp. has transferred a number of its guarantees to provide credit support for the energy trading business of NEG's subsidiaries to GTN thereby relieving PG&E Corp. of any obligation under these guarantees.

- As of November 30, 2000, PG&E GTN and PG&E Generating had common stock equity of $1.5 billion and $1.1 billion, respectively which is the carrying value of these investments on the books of PG&E Corp.

- The formation of PG&E National Energy Group, LLC may provide collateral for PG&E Corp. new money financing. Its investment in NEG subsidiaries might be pledged to secure new financing.

- Although NEG obtained FERC approval for the ring-fencing in an order issued January 12, 2001, PG&E believes that no CPUC approval is required for either of the ring-fencing transactions.

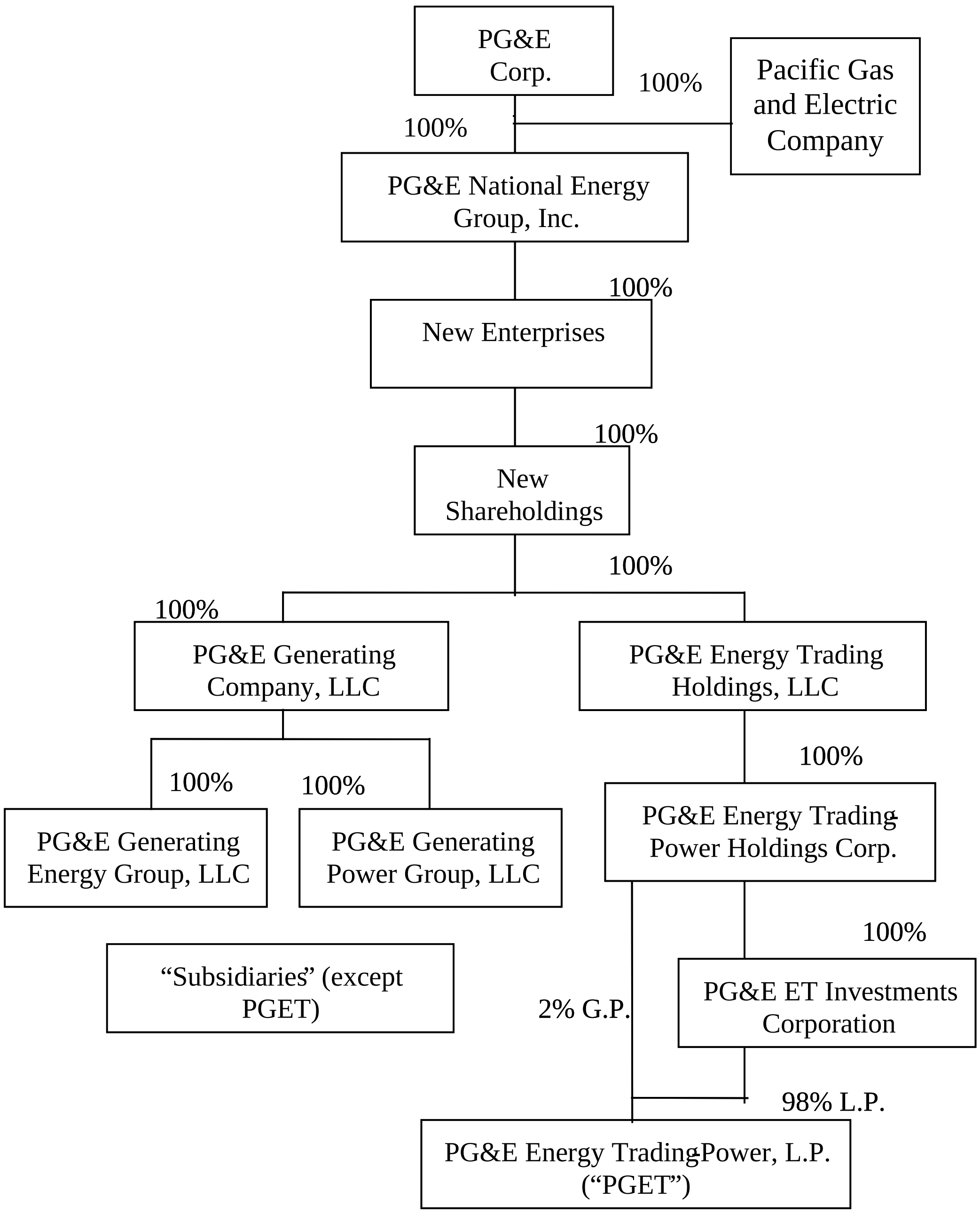
18. The legal organization of PG&E NEG and its relationship to the parent organization, PG&E Corp., prior to and following the ring fencing are shown in **Exhibits II-8** and **II-9**.

    - PG&E and its subsidiaries are not shown on either of these charts. PG&E NEG is a separate Corporate entity owned directly by PG&E Corp.

    - The difference between the two charts is the addition of PG&E National Energy Group, LLC in the ownership structure after the ring fencing, a limited liability corporation.

Exhibit II-8

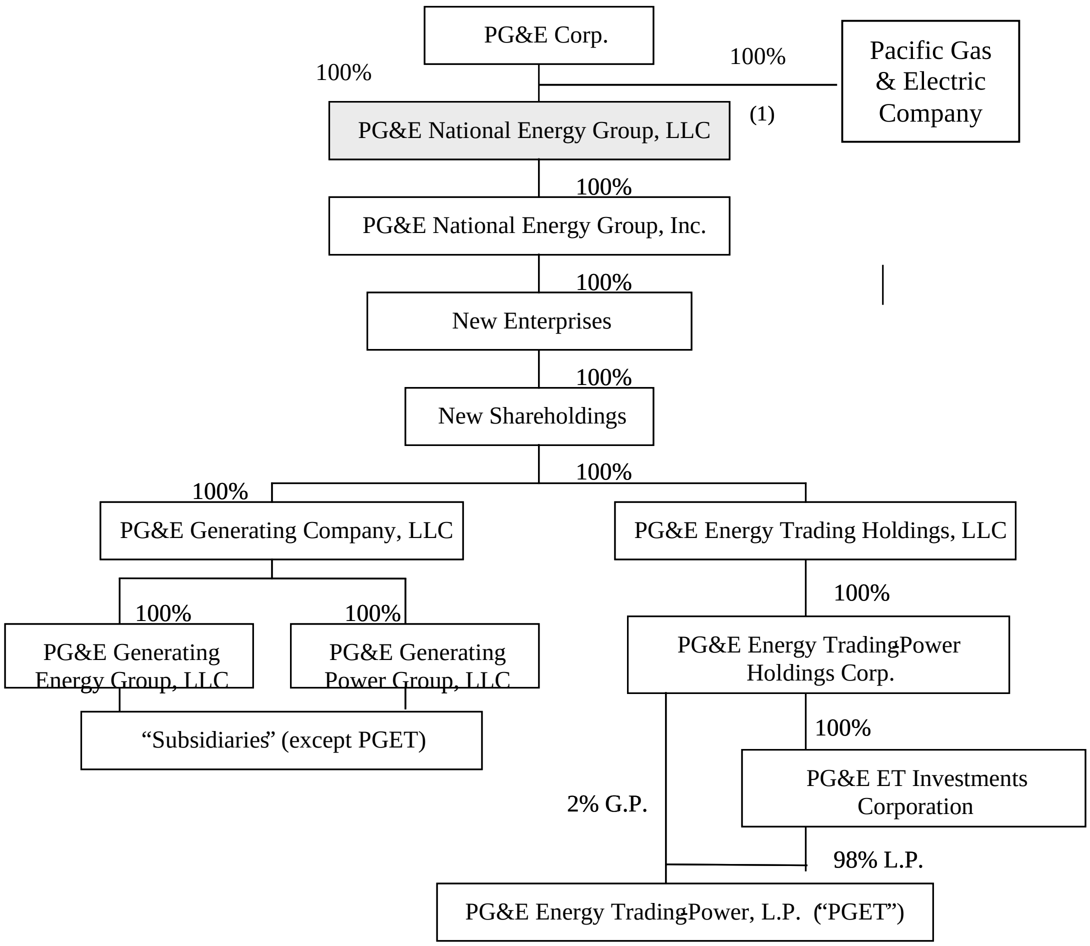
NEG Ownership Structure Prior to Ring Fencing



Source: BWG analysis.

Exhibit II-9

NEG Ownership Structure After Ring Fencing



Source: BWG analysis.

(1) New entity.

CHAPTER III

Power Purchases and Cash Flows

A. CPUC OBJECTIVE

In defining the scope of this task, the CPUC requested that BWG prepare an evaluation of multiple power supply cost and cash flow alternatives using actual costs for retained assets and contracts, and BWG's assumptions for energy costs for Qualifying Facility (QF) and "net short" positions.

B. BACKGROUND

This review of PG&E's power purchases and cash flows covers the last quarter of 2000 and the first quarter of 2001 – a period of significant market anomalies. Signs of dysfunction in the California energy market appeared as early as 1998 when ancillary services (AS) price spikes were first experienced. On July 17, 1998 the Federal Energy Regulatory Commission (FERC) authorized price caps for AS products at $250/MWh. The Independent System Operator (ISO) authority was extended until November 15, 2000. FERC allowed raising of the AS price cap from $250/MWh to $750/MWh. Price spike episodes soon spread beyond the AS markets to include the much larger market segments operated by the Power Exchange (PX) as well as other ISO administered products during the periods May 21-24, June 12-16, and June 26-30, 2000.

North Path (NP) 15 day-ahead (DA) prices spiked to $1,099/MWh on June 28, 2000. On July 1, 2000 the ISO responded by lowering its real-time energy price cap from $750/MWh to $500/MWh. This move signaled the beginning of several rounds of speculative switching by market participants between the DA and real time markets. The investor-owned utilities' loads (including PG&E's) steadily migrated from the PX day-ahead market to the ISO's real time arena.

The volatility of PX prices appeared to stabilize, but prices remained relatively high. The ISO's costs of real time power procurement became inflationary to the point where the $500/MWh price cap was rendered meaningless and the ISO resorted to emergency purchasing of Out of Market (OOM) generation. OOM costs were allocated among load serving entities (LSEs) on a pro-rata basis and PG&E's share was set at approximately 40 percent.

The migration of the utilities' loads continued. On December 8, 2000 the ISO made a decision to begin allocating OOM costs in proportion to each Scheduling Coordinator's (SC) contribution to under-scheduling in the PX DA market. To avert the repercussions of this change, LSEs began switching back to the PX arena, bidding higher prices for DA energy. A new round of bidding started, which led to a new round of PX DA price spikes.

During the last quarter of 2000, under-collections in PG&E's Transition Revenue Account (TRA) increased by approximately $4.4 billion as a result of increased power costs.

C. EVALUATIVE CRITERIA

BWG used the following criteria to evaluate PG&E's projections of purchased power costs and related cash flows.

- What are PG&E's cash requirements and cash balances under various alternatives relating to market prices, loads, and available resources?
- How is PG&E managing its available power supply resources?
- Has PG&E made accurate representations of its cash flows, cash requirements and cash balances?

D. WORK TASKS

During the period from December 26, 2000 to January 19, 2001, BWG performed the following tasks:

- Interviewed personnel involved in PG&E's power procurement activities.
- Interviewed PG&E personnel responsible for forecasting the generation contribution of owned facilities and long-term contracts.
- Reviewed PG&E's approach to forecasting its purchased power requirements and costs.
- Reviewed PG&E's cash forecasts and the existing links between the PG&E energy settlements group and the treasury organization.
- Analyzed PG&E's projections of load requirements and supply availability.
- Prepared a forecast of PG&E's daily cash requirements for purchasing electricity and gas under various price alternatives.
- Reviewed PG&E's projections of available cash balances and made adjustments to determine when cash is exhausted under various market price alternatives.

E. FINDINGS AND CONCLUSIONS

1. PG&E's January 16, 2000 cash flow projection, which indicates that its cash balances become negative on February 1, 2001, incorporates the following major assumptions:

    - One cent electricity rate increase in January through March 2001.
    - PX invoices are paid as scheduled.
    - QFs are paid in full in January, February, and March.
    - The estimated block forward payment of $149 million due from the PX on January 18, 2001 is not received.
    - Normal payments for gas supply are made.
    - No direct access payments are made.
    - No common dividends are paid.
    - Rate Reduction Bonds (RRB) payments are accelerated.
    - PG&E has continued access to its revolving credit agreement.
    - $45 million disbursement is made to replace workers' compensation insurance on February 5, 2001.

2. **Exhibit III-1** provides the dates that cash is depleted for alternative cash forecasts developed by BWG based upon the PG&E cash forecast adjusted for the effects of certain additional assumptions.

Exhibit III-1

Cash Flow Projections for Daily Energy Purchases

Price ($/MWh)	Cash Balance March 30, 2001 ($ million)	Negative Cash Date	Negative Cash Amount ($ million)
$55	$95	Early April, 2001	n/a
75	(62)	March 28, 2001	($38)
180	(512)	March 2, 2001	(254)
250	(786)	February 2, 2001	(158)
350	(1,312)	February 2, 2001	(147)
State Plan	278	April/May 2001	n/a

Source: BWG Analysis.
n/a – not applicable.

3. **Exhibit III-2** shows projected daily cash balances over a range of market clearing prices from $55 to $350, and a state plan scenario where the California Department of Water Resources (DWR) assumes responsibility for purchasing power to meet PG&E's daily loads net of PG&E-owned resources and long-term purchase power contracts.

Exhibit III-2
Projected Daily Cash Balances
($ million)

Day	PG&E Forecast	$55	$75	$125	$180	$250	$350	State Plan
1/22/01	761	777	762	741	719	765	649	777
1/23/01	745	773	752	727	700	739	615	773
1/24/01	775	803	775	746	714	748	615	803
1/25/01	611	639	605	571	535	523	421	639
1/26/01	639	667	614	569	518	489	363	667
1/29/01	492	520	461	412	357	322	188	520
1/30/01	525	553	488	435	376	335	193	553
1/31/01	535	563	492	434	370	324	173	563
2/1/01	(36)	562	489	429	361	312	154	565
2/2/01	(246)	312	236	167	90	28	(147)	325
2/5/01	(255)	290	214	143	62	(3)	(183)	306
2/6/01	(228)	304	226	153	69	0	(187)	323
2/7/01	(184)	336	256	181	92	21	(173)	358
2/8/01	(139)	378	297	220	127	51	(150)	404
2/9/01	(96)	380	315	228	103	35	(207)	417
2/12/01	(69)	397	291	222	115	23	(204)	436
2/13/01	(41)	412	305	233	123	28	(204)	454
2/14/01	(13)	427	319	245	131	32	(206)	472
2/15/01	(252)	476	367	289	173	70	(174)	524
2/16/01	(241)	449	356	249	122	6	(257)	507
2/19/01	(256)	473	359	269	138	18	(305)	535
2/20/01	(213)	520	404	310	176	51	(278)	585
2/21/01	(209)	523	406	309	172	42	(293)	591
2/22/01	(164)	556	436	337	196	63	(279)	627
2/23/01	(396)	545	422	313	162	16	(343)	626
2/26/01	(343)	586	462	350	196	47	(318)	670
2/27/01	(323)	592	467	353	196	42	(329)	679
2/28/01	(501)	403	277	160	0	(158)	(534)	493
3/1/01	(459)	427	300	180	18	(143)	n/a	520
3/2/01	(1,884)	175	45	(83)	(254)	(427)	n/a	277
3/5/01	(1,843)	199	68	(62)	(237)	(412)	n/a	304
3/6/01	(1,810)	215	83	(50)	(227)	(406)	n/a	323
3/7/01	(1,768)	240	107	(28)	(208)	(391)	n/a	351
3/8/01	(1,735)	266	133	(5)	(188)	(375)	n/a	380
3/9/01	(1,693)	257	120	(26)	(217)	(414)	n/a	379
3/12/01	(1,660)	275	137	(11)	(205)	(406)	n/a	400
3/13/01	(1,612)	305	167	16	(180)	(386)	n/a	433
3/14/01	(1,588)	312	173	20	(179)	(388)	n/a	443
3/15/01	(1,879)	245	105	(51)	(253)	(464)	n/a	379
3/16/01	(1,879)	208	64	(98)	(309)	(530)	n/a	350
3/19/01	(1,850)	219	75	(90)	(303)	(528)	n/a	364
3/20/01	(1,829)	238	94	(74)	(289)	(519)	n/a	386
3/21/01	(1,810)	240	95	(76)	(294)	(526)	n/a	391
3/22/01	(1,760)	273	127	(46)	(267)	(503)	n/a	427
3/23/01	(2,184)	225	76	(104)	(305)	(581)	n/a	388
3/26/01	(2,162)	230	80	(103)	(336)	(587)	n/a	396
3/27/01	(2,122)	253	102	(84)	(320)	(575)	n/a	422
3/28/01	(2,242)	115	(38)	(226)	(465)	(724)	n/a	287
3/29/01	(2,203)	137	(17)	(209)	(451)	(714)	n/a	312
3/30/01	(2,196)	95	(62)	(262)	(512)	(786)	n/a	278

Source: BWG Analysis.
n/a – not applicable.

- The assumptions used include:
  - Currently scheduled PX payments based on historical usage is suspended (approximating $2.6 billion in February and March, 2001).
  - Payments for PX purchases are required one day in advance (on Friday for weekends) beginning on January 18, 2001.
  - Daily gas payments are required beginning on February 1, 2001.
  - Purchase power projections are based on the forecasts developed by BWG.
  - Supply incorporates BWG's assessment of available PG&E-owned resources and contracts, including QFs.
  - Outflows incorporate payroll and other operations and maintenance (O&M) expense projections for retained assets as shown in PG&E's cash forecast.

4 PG&E's energy supply and demand forecasts and related cash flows included in the recent Emergency Rate Stabilization filings before the CPUC do not accurately portray near-term operating constraints and opportunities in responding to the current crisis.

- In its filings, PG&E's revenue requirements projections are based on a full-year planning horizon. Tracking cash flow developments requires monthly and daily forecast updates on customer demand, generation availability and fuel and bulk-power prices.
- Certain of PG&E's assumptions underlying its cash flow forecasts are not supported and are likely to result in overstated cash requirements.
  - The availability of energy from QF's during the first quarter of 2001 is understated.
  - Estimated ISO out-of-market (OOM) costs appear overstated.

5 PG&E did not provide an adequate basis for forecasting reduced QF generation for the first quarter of 2001.

- PG&E's estimates of QF production for December 2000 through March 2001 are shown in **Exhibit III-3**.

Exhibit III-3

PG&E Estimates of QF Production (MWh)

Month	Fixed Contracts	Short Run Avoided Costs (SRAC)	Crockett	Totals
December, 2000	34,569	1,551,459	144,646	1,730,674
January, 2001	19,908	1,502,863	128,497	1,651,268
February, 2001	17,562	1,391,652	118,466	1,527,680
March, 2001	20,107	1,461,037	117,402	1,598,547

Source: Data request for QF generation forecast.

- The first quarter 2001 monthly estimates represent a five to eight percent decline in production.
- The December 2000 estimate for Crockett is equivalent to an average generation rate of 194 MWs. This facility is on a special gas-indexed contract and operated at rates exceeding 240 MWs.
- PG&E believes QF output might be increased by three to five percent if it applies strong pressure on the QF owners.

6 PG&E does not have access to information on how the ISO prices and computes PG&E's OOM power purchases. As a result, PG&E is unable to project its cash flow requirements accurately and is unable to dispute improper or unfair ISO assessment and allocation of OOM charges in a timely manner.

7. PG&E estimates its OOM costs on the basis of worst-case scenarios emulating conditions that prevailed in early December 2000, which may result in significant overstatement of its OOM cash forecasts for January and February 2001.

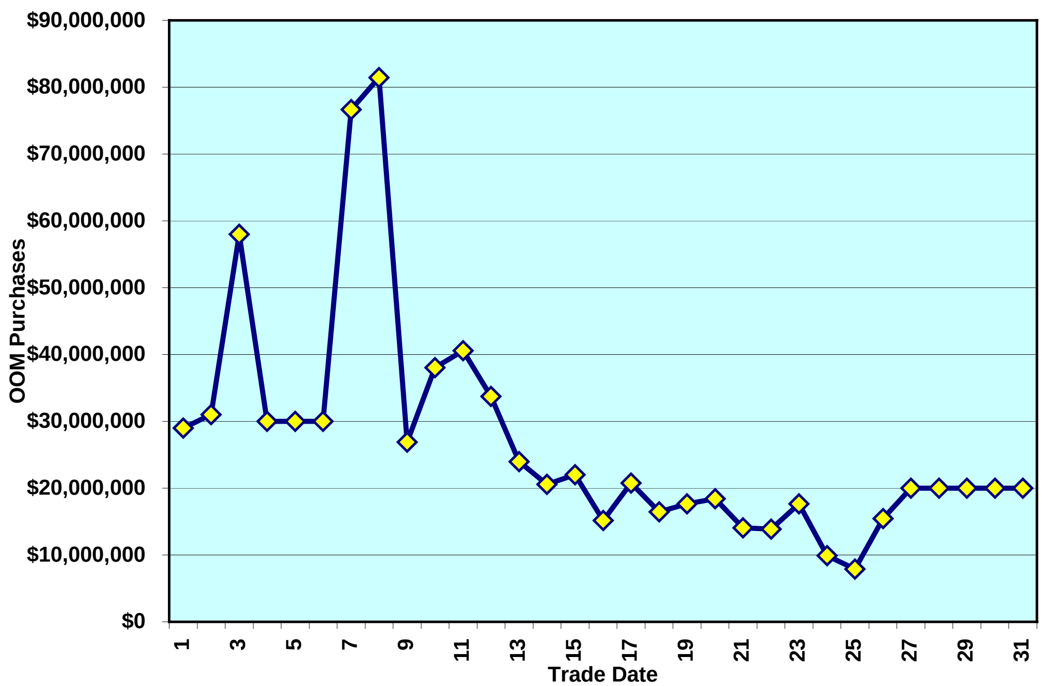
- PG&E's pro-rata share of OOM costs has historically been approximately 40 percent of the ISO total. In its recent cash flow forecast PG&E has assumed its share of OOM costs would increase to 75 percent of the ISO total beginning on December 12, 2000. PG&E has not provided support for this assumption.
- PG&E estimates total (ISO) OOM during the last five days of December and for January and February at $20 million per day. This figure does not

adequately reflect the downward trend in OOM costs experienced during the latter half of December.

- **Exhibit III-4** shows total estimated ISO OOM costs for December 2000. Total OOM costs averaged $43 million per day between December 1 and December 11. The average OOM cost declined to $18 million per day between December 12 and December 25, and was trending lower.

Exhibit III-4

December 2000 Total ISO OOM Purchases
($ million)



- **Exhibit III-5** summarizes PG&E's OOM cost projections for December 2000, and January and February 2001. Also shown in this exhibit are revised projections for PG&E's estimated OOM costs for the same months assuming: (1) PG&E's share of total OOM remains at 40 percent of the ISO total, rather than the 75 percent value assumed by PG&E; and (2) ISO total OOM costs are estimated at $15 million per day after December 25, 2000, rather than the $20 million per day assumed by PG&E.
  - Column A provides PG&E's $2,019 million estimate of total OOM Costs for December 2000 through February 2001.

- Column B provides PG&E’s projections for its three-month share of OOM costs, totaling $1,349 million.

- Column C revises PG&E’s projected three-month share of ISO OOM costs to $808 million by maintaining PG&E’s allocation of ISO total OOM costs at 40 percent for all periods.

- Column D further revises PG&E’s projected three month share of OOM costs to $680 million by lowering estimated total ISO OOM costs to $15 million per day after December 25, 2000 while maintaining PG&E’s share at 40 percent of total ISO OOM costs.

- Together, these changes would lower PG&E’s projected cash requirements for OOM payments through the end of February by $669 million.

- Based on information provided by PG&E on January 25, 2001, PG&E has revised its OOM cost projections significantly. The new estimates for January, February and March 2001 are $250, $219 and $246 million, respectively.

Exhibit III-5

Out Of Market Cost Projections

($ millions)

Month	**A** PG&E Estimates of Total ISO OOM Costs	**B** PG&E Estimates of PG&E’s Share of Total OOM Costs	**C** Revised Estimates of PG&E OOM Costs at 40% of Total OOM and Estimated Daily OOM of $20 million	**D** Revised Estimate of PG&E OOM Costs at 40% of Total OOM and Estimated Daily OOM of $15 million
December 2000	$839	$464	$336	$326
January 2001	$620	$465	$248	$186
February 2001	$560	$420	$224	$168
Totals	**$2,019**	**$1,349**	**$808**	**$680**

Source: BWG analysis of PG&E’s responses to data request for OOM cost projections.

8. Based on recorded and anticipated precipitation patterns in the winter of 2000-

2001, PG&E's forecasts of first quarter hydro generation are lower than normal.

- PG&E's surface water storage for hydro production is very low. Half the surface water available for hydro production is stored at Lake Almanor. Eighty percent of current hydro production is coming from aquifer outflows in the form of springs. Aquifer outflows can sustain approximately 7,000 acre-feet per day for generation. Another 1,200 acre-feet originate from Lake Almanor.

- During the first eleven days of January 2001, precipitation was 30 percent of normal. While January is normally the wettest month of the year, the long-range weather forecasts indicate that little precipitation is expected in the remainder of January 2001.

9. Because of low precipitation, PG&E is not expecting to increase its hydro production during the second quarter of 2001.

   - The January 2001 snow pack in the Sierras and the northwest is below normal.

   - PG&E plans to back down hydro generation in the second quarter of 2001. With the exception of Pit/McCloud, low water resources are expected throughout the system. Water will be available at Pit/McCloud from normal ground water sources.

   - Weather forecasts beyond two to three weeks are speculative. PG&E is forecasting a dry January and median precipitation levels for the balance of the year.

10. PG&E's energy cost estimates for December 2000 show very different market positions with respect to the ISO and PX.

    - The cash flows needed to meet PG&E's future PX and ISO commitments are included in the cash forecasts. **Exhibit III-6** summarizes PG&E's ISO and PX positions for December 2000.

Exhibit III-6

PG&E Energy Costs - December 2000

Market	MWh	$ Million	$ per MWh
Forward Market			
Gross Demand Purchases	(4,096,808)	($1,289.1)	$315
Must Take Generation Sales	3,636,136	962.4	265
Power Generation Sales	950,809	312.6	329
PX Forward Market	490,137	(14.2)	29
Bi Lateral Contracts	318,000	(30.7)	97
PX Payments		(44.9)	56
Block-Forward Market	560,000	148.5	265
PG&E PX Net Position	1,368,137	103.6	76
OOM	Not Available	(429.4)	Not Available
Real Time Energy			
Gross Demand Purchases	-2,411,197	(807.7)	335
Must Take Generation Sales	Not Available	$3.1	Not Available
Power Generation Sales	40,136	85.3	2,124
ISO Real Time and OOM	(2,371,061)	(1,148.8)	484
PG&E Net MWH and Payments [(1)]	(1,880,924)	($1,045.1)	$1,002

Source: PG&E Daily Cost Report dated December 31, 2000.
PG&E December 2000 OOM Forecast dated January 3, 2001
[(1)] MWh value adjusted to be compatible with the total dollar estimate.

- The cash forecasts for December 2000 PX payments are firm projections based on final invoices from the PX.
- ISO costs for OOM and real time energy are estimates and can not be finalized until the ISO invoices are received in March 2001.
- PG&E conducted the bulk of its transactions at a loss, purchasing more than four million MWh at $315/MWh and selling about 3.6 million MWh of must-take generation at $265/MWh.
- Considering December 2000's market conditions and prices, the net cost of purchasing power from the PX is noticeably lower than buying from the ISO.
- The net cost of PX purchases in December is $76 per MWh.

- PG&E's December 2000 transactions with the ISO cost $484 per MWh.

- PG&E sold generation from its non-must take units at an average price of $2,124 per MWh; but the amount sold was small compared to its real time and OOM energy purchases at prices ranging from $335 per MWh to more than $480 per MWh.

- December 2000 purchases in the real time market increased to combined cost of PX/ISO power to more than $1,000 per MWh.

11. PG&E's net shortage position for the first quarter of 2001 indicates that it faces its highest purchased power requirements in January 2001.

- **Exhibit III-7** provides BWG's estimates of PG&E's power requirements for January, February, and March 2001.

Exhibit III-7

PG&E Purchase Power Requirements for First Quarter 2001 (MWh)

MWh of Loads and Resources:	January	February	March
Total Load	7,352,648	6,453,696	7,088,494
PG&E's Thermal Gen			
Diablo	1,647,067	1,487,674	1,647,067
Hunters Point	52,080	47,040	52,080
Humboldt	74,214	67,032	74,214
Subtotal	1,773,361	1,601,746	1,773,361
PG&E Hydro	690,985	904,865	1,047,164
Helms	-166,817	-143,729	-179,829
Puget	-150,223	-96,377	0
Irrigation Districts Hydro	120,927	244,269	322,638
QFs	1,764,588	1,593,821	1,764,588
Bilaterals	688,800	619,200	688,800
Total Resources	4,721,621	4,723,796	5,416,722
Net Purchase Power Need	2,631,026	1,729,900	1,671,772

Source: BWG analysis, data requests for PG&E load and resources forecasts.

- PG&E's purchase power requirements for January, February and March 2001 are estimated at approximately 2.6, 1.7 and 1.7 million MWh, respectively. In average MWs, these needs are about 3,540, 2,570, and 2,250, respectively. The accuracy of these estimates is dependent on hydro generation availability.

- January 2001's supplemental energy needs are highest primarily because of below-average contribution from hydro generation.

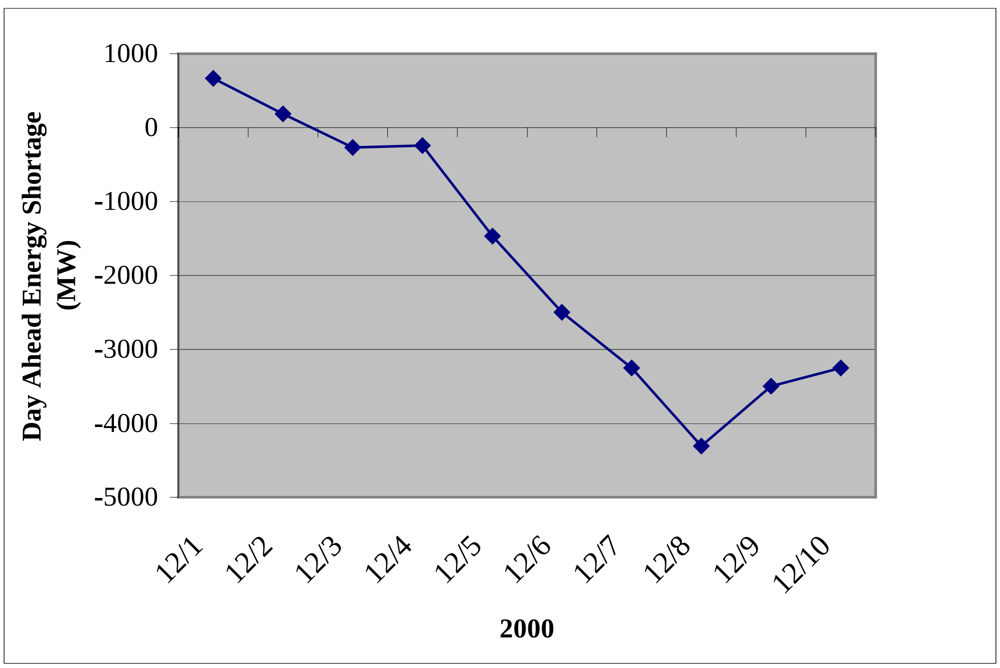
- The lowest purchase power requirements on a daily basis are expected in March. The primary contributor to reducing forecasted needs is the anticipated boost in hydro generation.

12. PG&E's bidding strategy during the first ten days of December 2000 resulted in a loss of its own generation to other buyers.

    - As shown in **Exhibit III-8**. For example, on December 8, 2000, PG&E was awarded only nine percent of the resources it required to meet its load obligations.

Exhibit III-8

Day Ahead Energy Shortage – 5:00 P.M.



Source: BWG analysis of PG&E's position in the DA market.

- PX market rules limit bids within a range from $0 to $2,500. Before December 8, 2000, PG&E capped its bids for DA energy to serve load at $249.99. PG&E entered bids for almost all of its energy requirements up to the $249.99 self-imposed limit. The prices bid did not capture the required energy to serve load because others submitted slightly higher bids.

- PG&E did not adjust its bidding strategy to regain its PX market share. PG&E's loss of generation to other market participants was evident as early as December 1, 2000.

13. While PG&E's strategy of bidding into the PX market at the $249.99 price was intended to minimize PG&E's exposure to congestion costs, it increased other ISO related costs.

    - The loss of PG&E generation to other market participants exposed PG&E and ratepayers to uncontrollable OOM costs. OOM for December, 2000 is estimated by PG&E at $793 million, of which PG&E estimates its share to be $429 million.

    - PG&E's bidding approach was intended to allow it to submit acceptable adjustment bids to manage congestion costs in order to reduce its exposure to potentially severe penalties.

    - Through the first week of December 2000, PG&E's bidding strategy focused on averting high congestion management charges by the ISO even when the result was a noticeable shift in generation procurement from the PX DA market to the ISO real-time markets. Preliminary information indicates that PG&E did not switch to bidding for energy exclusively in the PX DA market until December 12, 2000.

    - Subsequent to the ISO's decision to allocate the costs of OOM generation to the entities contributing to load under-scheduling, instead of the then-current pro-rata formula, PG&E switched to the PX DA market as the exclusive source of power to meet its loads around December 12, 2000.

    - PG&E changed its bidding strategy further around December 19, 2000 in response to the ISO's decision to allow its cap on adjustment bids to float with market clearing prices.

    - As a result of FERC's December 15, 2000 order, PG&E began netting its own generation out of its load requirements before submitting any bids to the PX. This option was not available earlier.

14. As indicated in **Exhibit III-9**, NP-15 paper transmission congestion has increased costs to PG&E.

- The cost estimates shown in Exhibit III-9 assumed 1,000 MW of congestion per hour on Path 15 in the DA market. Congestion is estimated to occur 18 hours per day, 200 days a year.

Exhibit III-9
NP 15 Congestion Cost Estimates

($ million)

Year	**Estimated Costs** Low	High
1998	$15	$15
1999	55	55
2000	170	375
Totals	**$240**	**$445**

Source: Date request for NP 15 congestion costs.

- Path 15 congestion and ISO's congestion management system and adjustment bids restrictions contributed to PG&E's earlier move towards the ISO's real time markets, exposing PG&E to high and unpredictable OOM costs.

15. With the exception of the Crockett, Helms pumped storage facility, Humboldt and certain hydro plants, PG&E's normal practice is to bid the output of the generating facilities at its disposal, along with the generation under contract, into the PX energy markets at a bid price of zero.

    - This practice assures that the PX schedules these resources as must-take generation, that PG&E becomes a price taker in these markets, and that PG&E is not adding to upward pressures on PX prices.

    - Crockett is a fully dispatchable QF and is bid into the market using a customized heat rate curve. PG&E's contract with Crockett requires the unit to operate between 120 and 260 MW.

    - The Helms facility is operated at the direction of the ISO and PG&E does not know in advance how the facility will be used. Since PG&E cannot use the Helms facility for its own peak shaving, higher cost resources must be purchased from the PX to serve load. PG&E has not determined the level of compensation it deserves for the ISO's use of Helms.

- PG&E schedules hydro generation from PG&E-owned facilities and contracts with irrigation districts and water agencies with the PX to minimize the overall cost of procured power. PG&E uses its own projections of PX DA prices to allocate hydro production preferentially to hours exhibiting the highest market-clearing prices (MCP).

16. It is unclear how PG&E bids its hydro generation.

    - PG&E originally indicated that prior to December 28, 2000, it bid the shaped hydro generation at a price of zero and that as of December 28, 2000 it netted all hydro output against PG&E customers' load.

    - Subsequent data appears to contradict this earlier statement. PG&E did submit non-zero bids for certain hydro resources in October, November, and December 2000. Submitting non-zero bids may have contributed to PG&E's inability to capture its own resources during this critical period.

    - BWG received data from PG&E on January 18, 2001 identifying hydro non-zero bids from October 1 through December 13, 2000. On January 19, 2001 BWG requested that PG&E provide a record of all non-zero hydro bids during 2000. This data was provided on January 25, 2000. It is being supplemented with a record of PX bid data for the same period. The two data sets will be analyzed to evaluate whether PG&E's hydro bidding activities have appreciably contributed to:

        - PX price spikes and overall escalation; and/or

        - Loss of market share of the PG&E-held resources in NP15 and ZP26.

17. PG&E actively participated in the ISO AS market, potentially using resources that might have higher energy value in the DA and real time markets.

    - PG&E uses its hydro facilities and the irrigation district resources as AS providers, bidding various products including regulation, spin, non-spin and replacement reserves.

    - Prior to November 2000, PG&E bid some irrigation district units into the AS markets even though the result was an accelerated depletion of stored energy.

    - In late November 2000, PG&E began to limit its AS bidding to regulation services only.

CHAPTER IV

Cash Conservation Activities

A. CPUC OBJECTIVE

In defining the scope for this task, the CPUC requested that BWG prepare an analysis of PG&E's proposed "cost cutting" or other cash conservation actions.

B. BACKGROUND

In December 2000, PG&E undertook a company-wide cash conservation analysis. The purpose of this effort was to identify and prioritize areas in which cash outlays could be deferred or eliminated. Individual opportunities were categorized into one of six "tiers" based upon their priority and expected effect upon PG&E and its customers.

- Tier 1 reductions were identified as those that had little or no customer effect, could be recovered within one year, could affect some long-term costs, and had no reductions in regular employee workforce.

- Tier 2 reductions were originally identical to Tier 1 except Tier 2 could be recovered within two years, rather than one. Later versions of the plan provided that Tier 2 reductions would have some likely customer effects and could increase some long-term costs.

- Tier 3A reductions had immediate customer effects in some areas and delayed customer effects for all other areas, but did not include reductions in PG&E's regular employee workforce.

- Tier 3B reductions were the same as Tier 3A, but included reductions in PG&E's regular employee workforce.

- Tier 4A reductions included the elimination of work related to Customer Information System (CIS) and Enterprise Application Integration (EAI) projects which do not affect immediate safety work, electric generation, gas transport or meter reading work.

- Tier 4B reductions included the elimination of all capital related to generation, gas transportation and immediate operations of gas and electric systems, and further reductions in the regular employee workforce.

Exhibit IV-1 summarizes the financial effect of the first two tiers of the cash conservation effort as projected on January 5, 2001.

Exhibit IV-1

Planned Cash Conservation Measures (1)
($ million)

Tier 1 Reductions (1)	**January**	**February**	**March**	**Total Dec 00 - Jun 01**
Corporate items - LTD sinking fund, severance pay, Nuclear Decommissioning Trust	$5.0	$13.0	$5.0	$48.0
General expenses - Overtime, temporary labor, contracts, core staff, financing, stretch accounts payable	5.0	5.0	5.0	29.7
Utility operations- T&D, customer service, CGT, general services	1.9	(2.2)	5.9	45.1
Power generation	.3	.3	.8	3.6
CFO & controller	.9	.5	3.0	6.2
Public affairs	.2	.2	.9	3.5
Human resources	.1		.05	.4
Legal services	.7	.7	(.2)	1.9
Total Tier 1	**$14.0**	**$17.4**	**$20.5**	**$138.4**
Tier 2 Reductions (1)				
General expenses - Overtime, temporary labor, contracts, core staff, financing, stretch accounts payable	33.0	(2.3)	(5.0)	4.3
Utility operations- T&D, customer service, CGT, general services	.5	.5	.9	2.7
Power generation	2.4	2.0	2.2	15.2
CFO & controller				3.3
Public affairs				$0.3
Human resources				$0.2
Legal services				$1.2
Total Tier 2	**$35.9**	**$.2**	**($1.8)**	**$27.2**

Source: PG&E's January 5, 2001Analysis.
(1) As of January 5, 2001.

C. EVALUATIVE CRITERIA

In addressing this audit area, BWG used the following evaluation criteria:

- When did PG&E recognize the need for cash conservation measures?

- What was the process for identifying and developing the cash conservation measures?
- What is PG&E's schedule for implementing cost conservation measures?
- Does PG&E have procedures in place to monitor implementation of its cash conservation measures and to update its cash flow projections?

D. WORK TASKS

During the period from December 26, 2000 to January 19, 2001, BWG performed the following tasks:

- Reviewed documents describing PG&E operations and its cash conservation program. Analyzed the conduct of the program and its effect on the organization.
- Interviewed PG&E officers and managers regarding the conduct of the cash conservation program.
- Reviewed PG&E's procedures for scheduling, staffing, and estimating jobs.
- Conducted interviews and reviewed documents to quantify the effect of the program on PG&E's cash flow.

E. FINDINGS AND CONCLUSIONS

1. Since 1997, PG&E has implemented a number of cost cutting programs.
    - As shown in **Exhibit IV-2**, existing cost cutting programs resulted in approximately $85 million of savings, roughly 3 percent of budget for controllable expenses in 2000.

Exhibit IV-2
Year 2000 Business Unit Budget Analysis (1)

($ million)

	O&M	Capital	Totals
Budget	$1,515	$1,300	$2,815
Actual	1,485	$1,245	2,730
Variance	30	55	85
Percent	2.0%	4.4%	3.0%

(1) Does not include Corporate items such as taxes, interest expense and depreciation.

Source: Data Request BWG-36.

- PG&E's total staffing declined approximately 11 percent (2254 employees) from 1997 to 2000, and its use of temporary and seasonal workers declined by 56 percent during the same period.
  - In 1997, the distribution and customer services business unit reorganized along functional lines, eliminating some manager and staff positions.
  - In 1998, the engineering and planning and operations, maintenance and construction departments were realigned to eliminate fifteen director and manager positions along with staff support.
  - In late 1999, the electric transmission and distribution departments were consolidated, eliminating redundant supervision in both departments.
- Since 1996, PG&E has undertaken two formal cost reduction programs. PG&E identified approximately 100 ideas for reducing overhead costs, and in the last two years has achieved a total annualized overhead cost savings of approximately $109 million. A subsequent program, initiated in 1997, generated additional annual reductions in the cost of purchased goods and services.
- PG&E instituted centralized program management of expense and capital work activities that reduced its distribution capital spending from $974 million in 1997 to $787 million in 2000, and overall capital spending from $1.5 billion to $1.2 billion during the same period. Among other things, this program requires budgeting and cost monitoring by the program managers and quarterly program reviews conducted by the CFO's organization for each functional area.

- In September 2000, PG&E eliminated one of its four customer service call centers, which is expected to save approximately $1 million per year.

2. During the period 1997 to 2000, PG&E's work force became more cost effective and most measures of electric system reliability improved.

   - As shown in **Exhibit IV-3**, while PG&E's staffing levels decreased during the period 1997 through 2000, the workforce became more cost-effective. Some of the ratios in the exhibit depict customers, product delivered to customers, or plant units. Compared to the number of employees, these ratios improved.

Exhibit IV-3

Staffing Level Trends - (1997-2000)

Year	**1997**	**1998**	**1999**	**2000**	**Percent Change**
Employees	21,177	20,262	19,538	18,923	(10.6%)
O&M expenses ($ billion) (1)	$2.409	$2.762	$2.680	$2.152 (2)	(10.7)
Electric customers	4,756,717	4,799,818	4,854,545	4,913,807(3)	3.3
kWh delivered	79,378,000	77,884,000	79,230,000	81,840,000	3.1
Miles of T&D lines	126,647	128,513	130,453	131,900	4.1
Gas customers	3,692,069	3,738,324	3,798,326	3,838,275	4.0
Bcf delivered	714,000	692,000	793,000	879,000	23.1
Miles of T&D mains	42,371	42,729	43,063	43,552	2.8
O&M expense/employee	$136,091	$162,274	$169,618	$113,734 (4)	(16.4)
Customers/employee (electric)	225	240	249	260	15.5
kWh delivered/employee	3,748	3,844	4,055	4,325	15.4
Miles of T&D lines/employee	5.98	6.34	6.68	6.97	16.6
Customers/employee (gas)	174	185	194	203	16.7
Bcf delivered/employee	33.7	34.2	40.6	46.5	38.0
Miles of T&D mains/employee	2.00	2.11	2.24	2.30	15.0

(1) Excludes Fuel
(2) Eleven months actual, one month estimated.
(3) As of September 2000.
(4) Estimate based on eleven months actual.

   - Despite declines in staffing, most measures of electric system reliability improved during the period 1997 through 2000.

     – The System Average Interruption Frequency Index (SAIFI), which is the ratio of unplanned sustained customer outages (excluding momentary, planned or transformer only) to the total number of customers, improved by 10.4 percent between 1997 and 2000.

   - Maintenance Related and Replacement Outages (MR&RO), which provides an indication of the number of maintenance-related and replacement outages per mile of distribution line, improved by 7.5 percent between 1997 and 2000.

   - System Average Interruption Duration Index (SAIDI), which measures electric transmission and distribution system quality, declined substantially in 1999. However, it was within five percent of its 1997 level for the year 2000. SAIDI measures the average length of time that customers are out of power during outages.

3. PG&E began implementing cash conservation efforts in December 2000.

   - There were strong indications eighteen months ago that California might face the energy crisis that it now confronts. As early as July 1999, the San Francisco Chronicle reported that "...California is veering toward shortages of electricity that could cause rolling brownouts or outright blackouts...". And, "California has been extremely slow in building new plants, relying instead on electricity surpluses from other states to meet rising demand." (SF Chronicle: July 22, 1999) The article described the opportunities for volatility in the bidding process for electrical energy and concluded that "customers...soon may wonder why the state chose a time of scarcity to deregulate an essential service."

   - As late as June 2000, PG&E felt that the effects of the problem would be limited to a reduction of earnings. PG&E did not anticipate that it would be constrained in its borrowings and did not develop a cash conservation analysis until November 2000.

   - The cash conservation plan developed by PG&E provided for some delayed payments in December 2000, but the majority of the actions identified were slated for implementation the first six months of 2001.

4. In December 2000, PG&E prepared a multi-tiered cash conservation analysis, which prioritized all cash expenditures into six tiers.

   - As described in Exhibit IV-1, the cash conservation measures identified were significant, but not exhaustive.

   - This process began with identification of the need for reduced expenditures and PG&E's CEO and CFO encouraged all officers to aggressively review budget items to identify opportunities for additional savings.

- During November and early December 2000, a group of financial personnel assessed each cash conservation opportunity and prepared the cash conservation analysis.

- PG&E has implemented some of the cash conservation plan's measures. As of January 12, 2001, PG&E began implementing measures which represent an estimated cash conservation savings of $327 million that will be realized through June 30, 2001. **Exhibit IV-4** provides the sources of the estimated savings that PG&E has implemented.

Exhibit IV-4

Cash Conservation Estimate as of January 12, 2001
($ million)

Source	**Amount**
Reductions in 2001 Budget	$40
Suspension of merit raise for management employees	9
Suspension of management performance incentive payments	83
Tier 1 measures	118
Tier 2 measures	27
Additional 1000 worker reductions	50
Total	**$327**

Source: "PG&E Cash Conservation Items," provided on January 11, 2001.

5. Cash conservation measures relating to payroll were not adopted for implementation.

- Deferment or reduction of employee or management compensation represents one of the most immediate ways to achieve savings. While PG&E's cash conservation plan identified a hiring freeze and eliminated management merit increases, it did not specifically identify salary reductions.

- Reductions or deferral of some employee or management compensation could amount to substantial cash conservation, as shown in **Exhibit IV-5**.

Exhibit IV-5

Potential Cash Conservation from Compensation Reduction
($ million)

	Approximate monthly compensation	**Monthly cash conservation with ten percent reduction or deferment**	**Monthly cash conservation with 20 percent reduction or deferment**
Total compensation	$130.0	$13	$26
Estimated management compensation	45.5	4.6	9.1

Source: BWG Analysis

- PG&E is concerned that any deferment or reduction in compensation would likely affect employee morale, or cause the loss of valuable employee talent.

- A five to ten percent reduction in salary might not affect PG&E's ability to be considered "competitive" or cause an exodus of quality personnel.

6. PG&E could eliminate the electric and gas discount provided to current employees and retirees to conserve more than $1 million per year.

   - PG&E allows a 25 percent discount on gas and electric bills for thousands of PG&E employees and retirees at a cost of approximately $1.2 to $1.3 million per year.

   - If this "benefit" were eliminated, PG&E's cash flow would increase by about $100,000 per month.

7. Beginning in December 2000, PG&E aggressively implemented its cash conservation plan.

   - The Tier 1 reductions were reviewed and approved by PG&E on December 15, 2000.

     – PG&E's team of officers approved implementation of the Tier 1 measures, with additional cash conservation areas to be reviewed over the next several weeks. These measures were not expected to affect customer service, system reliability, or safety.

     – General communications for suspension of discretionary expenditures were issued on December 18, 2000.

- Workforce notifications and overtime guideline communications from the officers all took place prior to December 18, 2000. The workforce reductions were primarily in temporary personnel (179) and did not affect regular PG&E employees.

- In early December 2000, PG&E suspended charitable contributions and extended accounts payable.

- On January 4, 2001, the CPUC approved an interim rate increase of approximately ten percent.

  - PG&E immediately implemented some Tier 2 actions, with additional areas to be reviewed during the subsequent week.

  - Additional contractors and consultants were eliminated and General Rate Case (GRC) consultants were suspended.

- On January 8, 2001, PG&E's officer team reviewed the next level of cash conservation measures.

  - Additional Tier 2 and some Tier 3 measures were implemented. Some of these actions, such as the bi-monthly meter reading program, will have a slight effect on customers.

  - On January 11, 2001, additional contractors were released, with more scheduled to be released over the next several months.

  - Communications regarding payment terms were made to key vendors.

- PG&E is currently reviewing Tier 3A and B items and 4A and B items.

- To date, PG&E has released 1,179 personnel (not regular employees) as a result of cash conservation efforts.

- Additional steps taken by PG&E include:

  - Reducing the 2001 budget, an action taken in December 2000, will result in a savings of $40 million over the first six months of 2001.

  - Freezing management merit pay increases will save or defer $9 million.

  - Withholding management performance incentive payments will save another $83 million.

  - Suspending payment of its common stock dividend for the fourth quarter of 2000 will save $116 million.

- PG&E continually monitors the results of approved cash conservation measures and has procedures in place to update its cash flow projections accordingly.

8. In the preparation of its cash conservation analysis, PG&E considered the effects that various actions might have on the safety needs of employees and the public.

   - In the December 13, 2000 cash conservation analysis, only Tier 4B items were indicated as having the potential to affect safety standards. Tier 4B items are remaining expenditures after implementing items in Tiers 1 through 4A.

   - Operations personnel indicated that they would take actions necessary to ensure safe conditions for employees and the public. Specific actions would include shutting off gas supply to prevent leaks and disconnecting power to damaged or downed service lines.

   - PG&E's President and CEO's December 13, 2000 letter to all employees reiterated the need to continue rigorous management of all expenditures. However, it also stated that the first priority is to stay focused on the job, "and that means no compromise on safety" and requested that employees "continue to do your job as safely as possible."

9. While PG&E's approach to implementing the first two tiers of its initial cash conservation measures is likely to have a minimal effect on customer service, the effects on the customer will increase if additional measures are implemented.

   - The implementation timetable for the cash conservation program was designed to minimize effects on the customer wherever possible.

     – Tier 1 measures were designed to have no customer impact.

     – While Tier 2 measures may have some customer impact, some of the Tier 2 changes included the reduction of temporary personnel such as some meter readers, resulting in estimated reads and a potential increase in call center volume.

     – PG&E believes customers will be affected by implementation of Tier 3.

   - No data is yet available to track the effects of the cash conservation effort on the measures of customer service utilized by PG&E. However, November 2000 data indicates performance levels below those of 1999.

CHAPTER V

Accounting Mechanisms to Track Stranded Cost Recovery (TCBA and TRA)

A. CPUC OBJECTIVE

In defining the scope of this task, the CPUC requested that BWG prepare a tabular presentation of TCBA activity and TRA activity for the life of the rate freeze.

B. BACKGROUND

In Decision 97-06-060, the CPUC established the Transition Cost Balancing Accounts (TCBA) and procedures relating to the closing of other balancing accounts and the transfer of balances to the TCBA. The purpose of the TCBA is to track all residual revenues and Competition Transition Charge (CTC)-eligible generation-related costs and other costs or revenues approved by the CPUC. The TCBA allows PG&E to track the recovery of its current transition costs, including the accelerated recovery of plant balances, generation-related assets and obligations. As required, PG&E established the TCBA effective January 1, 1998 with the transfer of $173.4 million from other balancing accounts, predominately from the Energy Cost Adjustment Clause (ECAC) and Electric Revenue Adjustment Mechanism (ERAM) balancing accounts.

PG&E's TCBA consists of a revenue section and three cost sections. The revenue section records all revenues from the Transition Revenue Account (TRA), fixed transition amount revenues, generation memorandum account revenues, and the imputed revenues associated with the ten percent rate reduction, and other amounts authorized by the CPUC. The cost sections include current costs, accelerated costs, and post-2001 eligible costs. PG&E is required to file monthly reports of all TCBA entries to the CPUC.

The TRA matches total revenues from sales of electricity and related services against the amount of the unbundled revenue components and CPUC-approved obligations. This matching facilitates the determination of the residual revenues, which are transferred to the TCBA. The unbundled revenue components consist of transmission, distribution, nuclear decommissioning and public purpose programs. CPUC-approved obligations consist of Independent System Operator (ISO) charges, Power Exchange (PX) charges and Diablo Canyon-related Incremental Cost Incentive Pricing (ICIP) exclusions, as well as shareholder participation credits. In addition, pursuant to Decision 99-05-031, the costs associated with the Consumer Education Fund (CEF) and the Electric Education Trust (EET) are recorded in the TRA. Beginning

January 1, 1998, all TRA over-collections were credited to the TCBA to offset the utility's transition costs.

Pursuant to Decision 97-11-074, PG&E files monthly reports of TCBA and TRA activity with the CPUC. As shown in **Exhibit V-1**, external groups have performed three audits and one verification review of PG&E's TCBA or TRA since the accounts were developed in 1998. The TCBA is routinely reviewed by the Office of Ratepayer Advocates (ORA) as part of the Annual Transition Cost Proceeding (ATCP), and the TRA is verified as part of the Revenue Adjustment Proceeding (RAP). The ORA is currently auditing TCBA activity for the period from July 1999 through June 2000. TRA entries for June 1999 through July 2000 will be verified after PG&E files its 2000 RAP in March 2001.

Exhibit V-1

External Reviews of PG&E's TCBA and TRA

Review and Report Date	Scope	Major Findings
Mitchell & Titus, LLP and BWG, performed for the CPUC. (December 31, 1998)	• Initial balances transferred to the TCBA. • Headroom revenues during the six-month period ended June 30, 1998.	• Headroom Revenue determined through the TRA and recorded in the TCBA is properly derived from total revenue recorded during the period from January to June 30, 1998, in accordance with procedures approved by the CPUC. • Balances in the balancing and memorandum accounts as of December 31, 1997 transferred to the TCBA were accurate and properly stated.
CPUC Energy Division	• TCBA regulatory review, entries during the six-month period ended June 30, 1998.	• Recommended a number of adjustments to the TCBA entries.
ORA - 1999 RAP (December 23, 1999)	• Review of entries to the TRA and transfer of balances to TCBA.	• Residual CTC revenues were transferred correctly from TRA to TCBA. • Corrections and adjustments recommended by BWG and Mitchell & Titus were made.
ORA - 1999 ATCP (February 23, 2000)	• TCBA entries during the period July 1998 through June 1999.	• Credit of $3.1 million plus interest to Post-Retirement Benefits Other than Pensions entry. • Adjustment of $0.4 million to reflect interest related to prior QF incentive disallowance. • Adjustment of ($0.2) million to revenues from departing load customers.

Source: Data Request AA-2

C. EVALUATIVE CRITERIA

BWG used the following criteria to review PG&E's TCBA and TRA entries:

- Has PG&E recorded entries to the TCBA and TRA as required by the CPUC?

D. WORK TASKS

During the period from December 26, 2000 to January 19, 2001, BWG performed the following tasks:

- Obtained a listing of modifications to PG&E's TCBA and TRA preliminary statements.
- Obtained a history of TCBA and TRA audit activity.
- Prepared a tabular presentation of PG&E's reported TCBA and TRA activity during the period from January 1, 1998 through November 30, 2000.
- Recalculated TCBA balances to reflect the elimination of the hydro valuation and the associated transfer of balances from the generation memorandum accounts.

E. FINDINGS AND CONCLUSIONS

1. As of November 2000, PG&E reported an under-collected balance (excess costs) in the TRA of $4.5 billion, largely as a result of increased costs of power purchases from the PX, which PG&E estimates will increase to $6.6 billion at the end of December, 2000.

    - **Exhibit V-2** provides a tabular summary of reported TRA entries for the period January 1998 through December 2000.

Exhibit V-2

PG&E Reported TRA Entries – 1998 to 2000
($ thousand)

Description	1998	1999	2000	Totals
Recorded Total Electric Revenues	($7,032,169)	($7,070,176)	($6,713,645)	($20,815,990)
Fixed Transition Amount Revenues	584,931	457,738	439,436	1,482,105
Transmission Revenues	316,086	331,489	530,438	1,674,890
Distribution Revenue Requirement	1,869,045	2,061,094	2,147,730	6,077,869
Nuclear Decommissioning	34,456	32,840	32,764	99,936
Public Purpose Programs	272,844	215,174	200,840	688,858
One-time Adjustments	0	31,206	(5,188)	26,018
Shareholder Participation Credits	(68,161)	(69,589)	(69,013)	(206,763)
Revenue Cycle Services Credits	0	(722)	(886)	(1,608)
SUBTOTAL	(4,022,968)	(4,010,946)	(3,437,524)	(10,974,685)
Less: Franchise Fees and Uncollectibles	38,822	37,060	34,393	110,275
ADJUSTED SUBTOTAL	(3,984,147)	(3,973,887)	(3,403,131)	(10,864,410)
ISO Charges for Transmission Support	216,646	386,330	63,775	169,874
Costs for Power Purchases from PX	2,346,411	2,482,644	9,636,659	14,465,714
Diablo Canyon-related ICIP exclusion	10,347	1,048	179	11,574
CEP & EET	0	36,800	2,447	39,247
SUBTOTAL Current Month Activity	(1,410,743)	(1,067,064)	6,299,929	3,821,999
Interest	2,272	(10,006)	108,296	100,562
Beginning of Month Balance	0	200,898	68,706	4,777,706
Total	(1,408,471)	(876,172)	6,476,931	8,700,267
Residual Revenue Transferred to the TCBA	1,609,492	944,879	195,143	2,749,514
End of Period Balance	$200,898	$68,706	$6,672,074	$6,672,075

Note: Some Revenue Cycle Services Credits in the Shareholder Participation Credits.
Source: Data request AA-1, Transition Revenue Account Report

- Between January 1998 and December 2000, PG&E recorded $20.8 billion dollars of electric revenue in the TRA, which when offset by the unbundled components of revenue and other CPUC-approved obligations, resulted in a transfer of $2.7 billion to the TCBA.

- As of December 31, 2000, TRA reported costs exceeded total reported billed revenues, resulting in an end of month under-collection in the TRA. If costs exceed revenues, no amounts are transferred to the TCBA and these balances are essentially treated as additional costs in the next month. **Exhibit V-3** shows the number of months with under-collected TRA balances during the period 1998 to 2000.

Exhibit V-3

Number of Months with Reported Under Collected TRA Balances

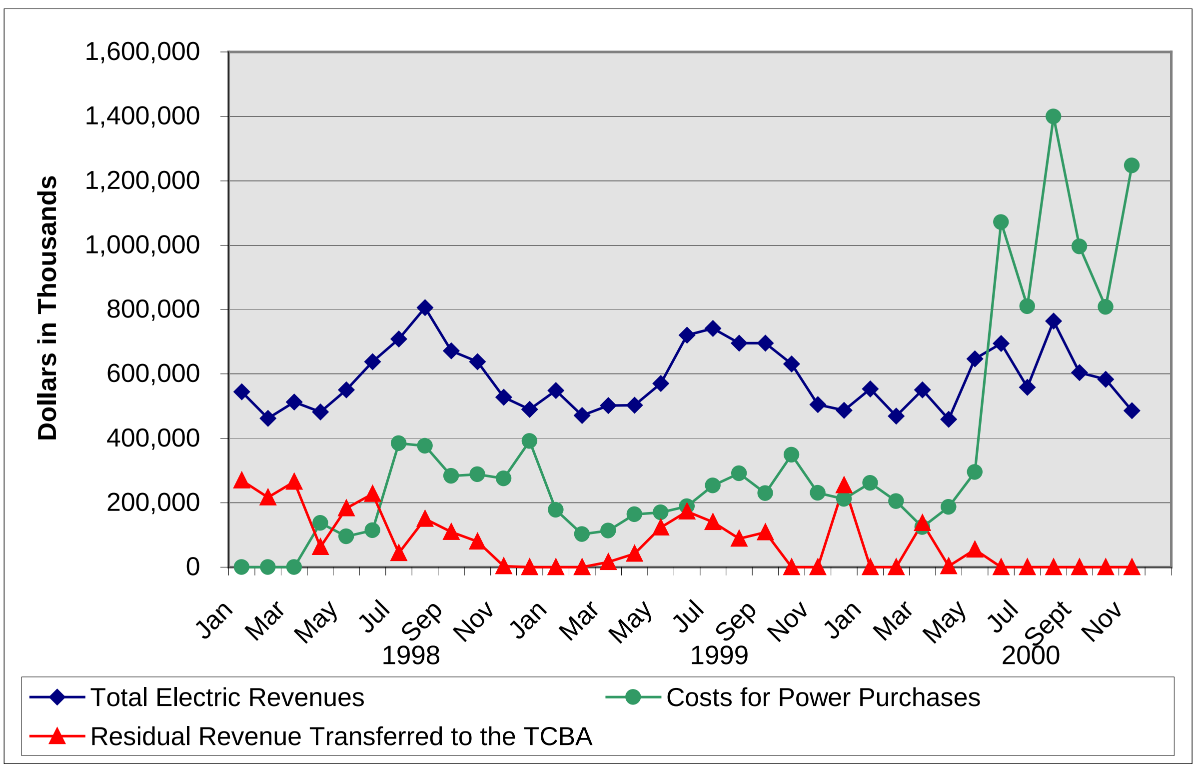
Year	**Number of Months**
1998	1
1999	5
2000 through November	8
Total	**14**

Source: Data request AA-1, Transition Revenue Account Report

- As shown in **Exhibits V-4** and **V-5**, in June of 2000, reported power costs began exceeding total reported electric revenues.

Exhibit V-4

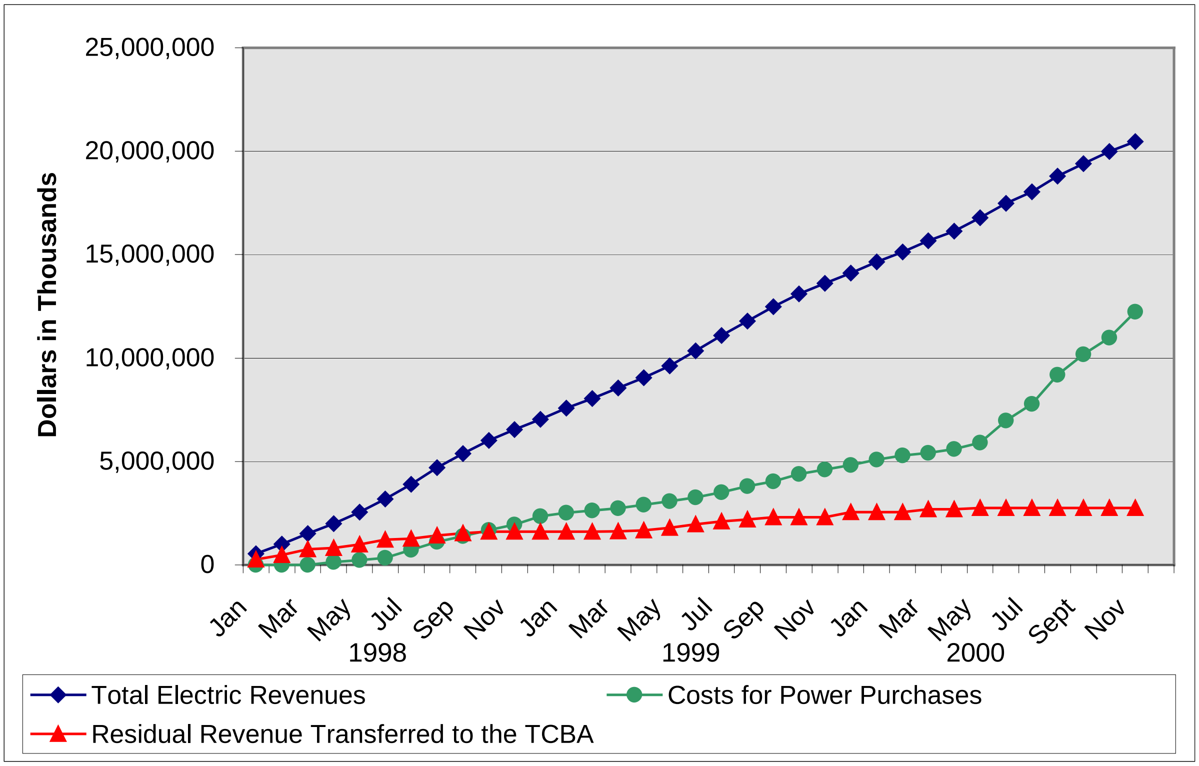
Comparison of TRA Revenues and Power Costs



Source: Data request AA-1, Transition Revenue Account Report

Exhibit V-5

Cumulative TRA Revenues and Power Costs



Source: Data request AA-1, Transition Revenue Account Report

2. TCBA balances without the hydro valuation and the associated generation memorandum account transfers result in a December 31, 2000 under-collected balance, estimated at approximately $50 to 80 million.

    - PG&E reports an estimated $1.9 billion over-collected balance (excess revenues) in the TCBA as of December 31, 2000; however, these costs include the market valuation of PG&E's hydro facilities.

    - In August 2000, PG&E credited the revenue section of the TCBA with $2.1 billion to reflect the excess market value over book for its hydro facilities. At the same time, PG&E transferred the August $790.9 million credit balance in the generation memorandum accounts to the TCBA. Subsequently, PG&E accelerated recovery of its stranded costs.

    - A comparison of annual generation memorandum account balances is provided in **Exhibit V-6**. The generation memorandum account balance is $1.5 billion as of December 31, 2000. Decision 01-01-018 required

PG&E to segregate this amount until the CPUC considers the proposal by the Utility Reform Network (TURN) to consolidate the TRA and the TCBA account balances.

Exhibit V-6

Generation Memorandum Account Activity – 1998 -2000
($ thousand)

Section	**Total** **All Periods**
1998	($426,936)
1999	(352,419)
2000 through December	($1,461,419)

- Between January 1998 and December 2000, PG&E recorded $9.2 billion dollars of revenue and $10.9 billion of costs in the TCBA. **Exhibit V-7** provides a tabular summary of TCBA entries for the years 1998 through 2000, as reported by PG&E. These amounts do not reflect the end of year transfers from the generation memorandum accounts.

Exhibit V-7

PG&E Reported TCBA Entries
($ thousand)

Section	**1998**	**1999**	**2000**	**Totals**
Revenue (1)	($3,025,956)	($2,491,374)	($5,338,531)	($10,855,861)
Currently Incurred Costs - Unamortized	2,385,854	2,192,050	69,706	4,647,613
Currently Incurred Costs - Amortized	620,336	398,647	252,860	1,271,843
Accelerated Costs	0	71,818	2,227,420	2,299,238
Adjustments/Interest	(2,934)	27,816	(15,072)	9,809
Balance	**(22,700)**	**198,957**	**(2,803,614)**	**(2,627,358)**
Post 2001-Eligible Costs	6,301	21,571	72,839	100,711
Adjustments/Interest	832	(32)	1,390	2,190
End of Period Balance	**(15,567)**	**220,496**	**(1,871,569)**	

(1) Includes generation memorandum activity identified in Exhibit V-6.
Source: Data Request AA-1 Transition Cost Balancing Account Report

3. TURN's October 18, 2000, report "Cooking the Books," which provides an analysis of entries to PG&E's TCBA and TRA does not reflect all entries to these accounts.

   - On page 10 of its report, TURN's provides an August 2000 TRA ending balance of $2.2 billion. This value represents the under-collected TRA balance reported by PG&E as of that date, which resulted from costs in excess of revenues.

   - On page 11 of its report, TURN determines a total recovery from 1997 through August 2000 of $8.3 billion. TURN appears to have made the following assumptions.

     – TURN uses monthly credits to the TCBA as a proxy for stranded cost recovery.

     – TURN includes only months with credit balances. As a result, subsequent adjustments to prior month's entries that result in debit entries are not included. This serves to overstate the $8.3 billion revenue amount.

     – Monthly credits from PG&E's generation are net of "incremental" costs.

     – TURN does not include the estimated market value over book for PG&E's hydro facilities that PG&E recorded in the TCBA in August 2000. However, TURN does include the associated monthly transfers from the generation memorandum account that, absent the valuation, would not be credited until December 2000.

   - On page 11 of its report, TURN indicates that PG&E's generation netted $1.5 billion during the first eight months of 2000. Based on information available to date, this number includes credit balance revenues from Diablo Canyon, QFs, power purchase contracts, and PG&E's must-run and non-must-run hydro and fossil plants.

     – The $1.5 billion includes revenues for only those months for which revenues exceed costs, and does not incorporate any monthly losses. **Exhibit V-8** provides a comparison of values used by TURN and net revenues during the period January through August 2000.

Exhibit V-8

PG&E Generation Revenues – January through August 2000
($ million)

Section	**Total Net Revenue**	**TURN Monthly Credit Balances Only**	**Difference**
Diablo Canyon, QFs and power purchase contracts	$381	$677	$296
Generation memorandum account balances (PG&E's must-run and non-must run fossil and hydro generation)	791	794	3
Totals	**$1,172**	**$1,471**	**$299**

- The $1.5 billion reflects credits from January through August 2000, only and does not include additional revenues during September through December 2000, or losses from 1998 and 1999.
- Revenues are net of "incremental" costs, but do not include sunk costs or revenue requirements.

- TURN's position that net revenues from PG&E generation are deposited into the TCBA and do not offset the costs of power purchases made by the utilities accurately reflects the approved functioning of the balancing accounts.
- As of December 31, 2000, PG&E reported a TRA balance of $6.7 billion and a TCBA balance of $1.9 billion reflecting an under collection of $4.8 billion if the two accounts were netted as proposed by TURN. The $1.9 billion TCBA balance includes the hydro valuation and the generation account year-end transfers.

CHAPTER VI

Inter-Company Cash Flows

A. CPUC OBJECTIVE

In defining the scope for this task, the CPUC requested that BWG prepare a flow of earnings, dividends, retirements of debt or equity by PG&E and subsequently by PG&E Corp., showing, if possible, the use for the benefit of affiliate investment/funding.

B. BACKGROUND

PG&E Corp. is composed of many legal entities, and this chapter examines the flow of cash for financing purposes among three groups of legal entities as follows:

- PG&E Corp. is the holding company that owns all other subsidiaries and affiliates. It normally reports financial statements on a consolidated basis (rolling up the results of all subsidiaries) in the annual report and on a stand-alone basis (the holding company entity's individual results only) as required by the SEC in the 10-K Report.

- PG&E is the regulated utility and is composed of approximately 32 Corporations, trusts, partnerships, limited liability companies, and foreign Corporations. PG&E reports financial results on stand-alone consolidated basis, that is, the 32 entities are reported as one. PG&E's results are consolidated into PG&E Corp.'s results.

- NEG and four other PG&E Corp. subsidiaries are the unregulated businesses. The financial results from this group of entities are normally reported as part of PG&E Corp.'s consolidated statements. NEG is comprised of three business units: power generation; electric and gas trading; and gas transmission.

Until the end of December 2000, PG&E Corp. had two cash pools, one for PG&E and one for PG&E Corp. and all other affiliates. PG&E has not participated in any cash management pool of an affiliate company in recent years. The banking and money management department of PG&E Corp. managed both pools, and the funds were not co-mingled, although there may be loans between the two pools. At the end of December 2000, the Corporate cash pool was divided. The cash for the NEG generation, trading and gas transmission business units was separated from the PG&E Corp. cash pool.

Cash does flow from one entity to another for specific financial purposes at specific times. For example, PG&E has paid cash dividends to PG&E Corp. on a quarterly basis. The holding company in turn has paid shareholders cash dividends on a quarterly basis. Other typical transfers of cash from PG&E to PG&E Corp. are for tax payments and common stock repurchases. PG&E Corp. generally does not provide funds to PG&E, but does make ongoing investments in and loans to the NEG businesses.

There are some cash payments from PG&E to PG&E Corp. and other affiliates for goods and services. For example, NEG's PG&E Gas Transmission Corporation provides gas transportation services to PG&E. Also, PG&E, PG&E Corp. and other affiliates provide various administrative services to each other. The payments for these services are part of normal operating activities and do not show up in consolidated cash flow statements, other than as a part of the net income line.

C. EVALUATIVE CRITERIA

BWG used the following criteria to analyze cash flows within PG&E Corp.:

- How has PG&E Corp. deployed cash provided by PG&E?
- Have PG&E Corp. or other affiliates provided cash to PG&E?

D. WORK TASKS

During the period from December 26, 2000 to January 19, 2001, BWG performed the following tasks:

- Examined published financial reports for the years 1997 through 2000, their associated work papers, testimony transcripts, and documents dealing with the relationships among the legal entities of PG&E Corp.
- Performed analyses of the flow of cash among affiliates. Refined these analyses through interviews with PG&E Corp. accounting personnel.
- Prepared exhibits which were verified for accuracy with PG&E.

E. FINDINGS AND CONCLUSIONS

1. In the past few years, PG&E has generated substantial amounts of cash from profitable operations and financing activities.

- **Exhibit VI-1** summarizes the cash generation and application by PG&E, the utility, from 1997 to 1999 and for the first nine months of 2000. In 1999, PG&E generated $3.4 billion in cash, of which $1.3 billion was transferred to PG&E Corp. for common stock repurchases and dividends.

- PG&E paid $278 million more in cash for income taxes to PG&E Corp. than was actually paid by PG&E Corp. to governments in 1999. PG&E Corp. calculates taxes for PG&E on a stand-alone basis and PG&E pays the calculated amount to PG&E Corp. The holding company then prepares a single consolidated tax return for all PG&E Corporate entities. In recent years, PG&E Corp.'s actual tax due on a consolidated basis was less than the amount paid to PG&E Corp. by PG&E for its share of the taxes. PG&E Corp. has had the use of the difference to apply to other activities.

- PG&E has used these positive cash flows to fund capital expenditures, reduce its debt and preferred stock, and to provide cash to PG&E Corp. in the form of common stock repurchases, dividends paid, and income taxes paid.

- In Exhibit VI-1, dividends paid are separated into dividends paid for PG&E preferred stock to individual preferred stockholders, and dividends paid to PG&E Corp. for common stock.

- In the first nine months of 2000, PG&E generated $1.8 billion in cash, of which $632 million was transferred to PG&E Corp. for common stock repurchases and dividends.

Exhibit VI-1

Generation and Application of Cash by PG&E
($ million)

Category	1997	1998	1999	Q1-Q3 2000
Cash Generated				
Operating activities	$1,768	$2,610	$2,200	$1,297
Sale of assets		501	1,014	0
Other investing activities		40	234	38
Net borrowings under credit facilities		668		468
Long-term debt issued	355			
Sale of rate reduction bonds	2881			
Other financing activities			1	
Total Cash Generated	**$5,004**	**$3,819**	**$3,449**	**$1,803**
Cash Applied - PG&E				
Capital expenditures	1,522	1,382	1,181	874
Other investing activities	117			
Net repayments under credit facilities	681		219	
Long term debt retired	852	1,413	672	291
Preferred stock redeemed		108		
Preferred dividends paid	40	28	25	18
Other financing activity	14	5		
Total Cash Applied in PG&E	**$3,226**	**$2,936**	**$2,097**	**$1,183**
Cash Applied - PG&E Corp.				
Common stock repurchased		1,600	926	275
Dividends paid	699	416	415	357
Total Cash Applied to PG&E Corp.	**$699**	**$2,016**	**$1,341**	**$632**
Total Cash Applied	**$3,925**	**$4,952**	**$3,438**	**$1,815**
Cash generated less cash applied	1,079	-1,133	11	-12
Income Taxes				
Cash paid for income taxes – PG&E	841	1,115	1,001	0
Cash Paid For Income Taxes – PG&E Corp.	801	770	723	23
Difference	40	345	278	-23

Source: 1997 to 1999 PG&E Corp. Annual Reports, PG&E Corp.. 10Q for the third quarter 2000.

2. Historically, cash has flowed in only one direction, from PG&E to PG&E Corp., and then to the unregulated affiliates.

   - Transfers of cash from PG&E to PG&E Corp. are used for several purposes including:

     – Payment of dividends to shareholders

     – Repurchases of Corporate stock

     – Payment of consolidated taxes to governments

- Repayment of borrowings under credit facilities
- Investments in and loans to subsidiaries.

- **Exhibit VI-2** summarizes the generation and application of cash by PG&E Corp. from 1997 to 1999. As shown, from 1997 through 1999, PG&E Corp. received $4.0 billion from PG&E in the form of $1.5 billion in dividends and $2.5 billion in common stock repurchases, representing 69 percent of the cash inflows to PG&E Corp. over this period. PG&E Corp. invested $0.8 billion in its other subsidiaries, $2.7 billion to buy back its stock from the public, and $1.5 billion to pay dividends to its shareholders.

- The 10K amounts did not include a $40 million capital contribution from PG&E Corp. to Energy Services in 1999 or $39 million to Energy Trading in 1998. Therefore, the total investment in non-utility subsidiaries shown in Exhibit VI-2 for 1998 is $39 million more than shown in the 10K and the total investment shown above for 1999 is $40 million than shown in the 10K.

- $690 million spent in 1999 for repurchases of PG&E Corp. by its subsidiary Elm Power Corporation is shown as common stock repurchase, rather than an investment in a subsidiary as it is designated in the 10K.

Exhibit VI-2
Generation And Application Of Cash By PG&E Corp.
($ million)

Category	1997	1998	1999	Total
Cash Generated				
Cash provided by operating activities	$770		$163	$933
Dividends paid by PG&E	699	416	415	1,530
Return of capital by PG&E - share repurchases		1,600	926	2,526
Common stock issued	54	63	54	171
Short-term debt issued		683		683
Other financing activities				0
Total Cash Generated	**$1,523**	**$2,762**	**$1,558**	**$5,843**
Cash Applied				
Net cash loss from operating activities		500		500
Capital expenditures		8	8	16
Investments in subsidiaries	150	616	72	838
Other investing activities			12	12
Common stock repurchased	804	1,158	693	2,655
Short-term debt redeemed			157	157
Dividends paid	524	470	465	1,459
Other financing activities	44	2	5	51
Total Cash Applied	**$1,522**	**$2,754**	**$1,412**	**$5,688**
Cash Generated Less Cash Applied	**$1**	**$8**	**$146**	**$155**

Source: PG&E Corp. 1999 10K, interviews with PG&E personnel.

CHAPTER VII

Affiliate Earnings in the California Energy Market

A. CPUC OBJECTIVE

In defining the scope of this task, the CPUC requested that BWG identify the earnings for each of PG&E's affiliates attributable to business activity in the California energy market.

B. BACKGROUND

PG&E's unregulated affiliates are organized under NEG, which had operating revenues of $11.6 billion in 1999. Through November 2000, NEG's operating revenues were $14.4 billion. NEG develops, constructs, operates, owns, and manages independent power generation facilities that serve wholesale and industrial customers through PG&E Generating Company, LLC (PG&E Gen.) and its affiliates; owns and operates natural gas pipelines, natural gas storage facilities, and natural gas processing plants, primarily in the Pacific Northwest, through PG&E Gas Transmission Northwest (PG&E GT); and purchases and sells energy commodities and provides risk management services to customers in major North American markets, including the other NEG non-utility businesses, unaffiliated utilities, marketers, municipalities, and large end-use customers through PG&E Energy Trading - Gas Corporation, PG&E Energy Trading - Power, L.P., and their affiliates (collectively, PG&E Energy Trading or PG&E ET).

PG&E Gen. participates in the development, construction, operation, ownership and management of non-utility electric generating facilities that compete in the United States power generation market. It has thirty operating power plants representing more than 6,600 megawatts of capacity. Further, it has thirteen power plants in development or construction, which will increase its capacity by 10,800 MW to 17,400 MW total. PG&E Gen.'s operating power plants are in the east and northwest, and it does not own any operating power generating facilities in California. However, it is constructing the La Paloma Project, a 1,048 MW natural gas-fired merchant facility in McKittrick, California. PG&E Gen. is also developing the Otay Mesa Project, a 510 MW natural gas-fired merchant facility in Otay Mesa, California. PG&E Gen. is also developing small peaking power facilities in Southern California and San Francisco.

PG&E ET is a FERC-authorized power marketer that is active in all North American Electric Reliability Council (NERC) regions. PG&E ET buys and resells electric power in the wholesale electric market through its marketing and trading group. PG&E ET transports, schedules, and settles on its own behalf. PG&E ET also provides risk management services to NEG and to its customers.

NEG participates in the "midstream" portion of the gas business through PG&E GT. PG&E GT owns and operates gas transmission pipelines and associated facilities that extend over 612 miles from the Canada-U.S. border to the Oregon-California border. PG&E GT provides firm and interruptible transportation services to third party shippers on an open-access basis. Its customers are principally retail gas distribution utilities, electric utilities that use natural gas to generate electricity, natural gas marketing companies, natural gas producers, and industrial consumers.

The stock of PG&E Energy Services Corporation (PG&E ES), along with the bulk of its commodity business, was sold to Enron Energy Services Operations, Inc., on June 29, 2000. The value added services business was sold to Chevron Energy Solutions, LP, on July 21, 2000. The residual assets of PG&E ES are now held by PG&E Energy Services Ventures, Inc. (Ventures). These assets include three substation contracts that obligate Ventures to perform substation maintenance and supply electricity to the substations. The three customers are all above the 20 kW threshold for small commercial customers. The electricity is currently being supplied through a power marketer, California Polar Power Broker. PG&E Corp. is actively trying to sell these three contracts.

C. EVALUATIVE CRITERIA

BWG used the following criteria to analyze affiliate earnings:

- Do affiliates earn income as a result of business activity in the California energy markets?

D. WORK TASKS

During the period from December 26, 2000 through January 19, 2001, BWG performed the following tasks:

- Reviewed documents, including responses to Administrative Law Judge (ALJ) questions, Annual Transition Cost Proceeding (ATCP) filings and work papers, divestiture compliance filings, sunk cost filing, The Utility Reform Network (TURN) report of October 2, 2000, and PG&E Corp.. and affiliate financial statements.

- Conducted interviews with NEG and PG&E employees.

- Performed analyses of the affiliate earnings.

E. FINDINGS AND CONCLUSIONS

1. Based on BWG's analysis, NEG's 2000 earnings associated with affiliate activities in the California energy market are approximately $117 million prior to income taxes and PG&E Corp. allocations (see **Exhibit VII-1**.)

Exhibit VII-1

NEG Earnings from Gas Transmission to the California Border - 2000
($ million)

Category	PG&E GT	PG&E ET	Total
Revenues	$152.8	$677.7	$830.5
Operating Expenses	59.8	635.3	695.1
Operating Income	92.9	42.4	135.3
Other Income	1.4	8.1	9.6
Interest Expense (Income)	27.5	(0.1)	27.4
Earnings Pre-Tax and PG&E Corp.. Allocations	$66.9	$50.4	$117.5

Source: Data Request MAL 2.2, BWG analysis.

2. PG&E GT operates extensively in the California energy markets.

   - Approximately 68 percent of PG&E GT's natural gas volume is delivered to the California border, and an approximation of California energy market-related revenues and earnings can be derived by taking total revenues and earnings and allocating them using the percentage of gas volume delivered to California.

- PG&E GT 2000 revenues and earnings before income taxes and PG&E Corp. allocations are estimated at $225 million and $98.4 million, respectively. Based on an allocation of 68 percent, the amount of PG&E GT revenues and earnings before income taxes and PG&E Corp. allocations attributable to the California energy market are estimated at $152.8 million and $66.9 million respectively, for the year ended December 31, 2000.

- The 68 percent allocation factor may understate the revenues and earnings associated with California energy markets, as a portion of the gas is delivered to power plants outside of California which serve California load.

3. PG&E ET actively participates in the California gas and electric energy market, and a disproportionate share of its total earnings in 2000 was derived from doing business in California when compared to California's percentage of total PG&E ET revenues.

   - PG&E ET operated at a loss in 1997 through 1999. **Exhibit VII-2** identifies revenues and losses from continuing operations for PG&E ET for 1997 through 2000.

Exhibit VII-2
PG&E ET Net Revenues and Earnings 1997 – 2000
($ million)

	1997	1998	1999	2000
Operating Revenues	$4,808	$8,509	$10,521	$15,499
Income (Loss) from Continuing Operations	$(19)	$(6)	$(34)	$86.8

Source: 1999 PG&E Annual Report / Response to DR-MAL-2

   - PG&E ET estimates California power and gas revenues at $677.7 million or 4.4 percent of total revenues for the US and Canada. PG&E-ET's estimate of its gross margin attributable to California is $56.8 million or 23.9 percent of total gross margin.

   - PG&E ET's estimated net income attributable to California was $18.8 million or 21.7 percent of PG&E ET's total. However, PG&E ET's allocation factors used to develop earnings estimates may understate earnings for California energy market-related business activities.

     - In estimating net earnings associated with California activities, PG&E ET allocated indirect expenses including administrative and general (A&G), interest, depreciation and amortization, and other expenses using the percentage of accrual gross margin earned in California to total accrual gross margin (29.4 percent).

- In its estimates, PG&E ET did not allocate to California any of the $21.9 million “Transition Expenses” associated with PG&E ET’s relocation from Houston to Bethesda.

- In its estimate, PG&E ET did not use metrics to allocate administrative and general, and other indirect expenses on a state-by-state basis, but rather used the accrual gross margin of 29.4 percent.

- Direct power and gas expenses for California contracts equal 4.1 percent of total direct expenses for PG&E ET as a whole. Consistent with PG&E GT’s methodology for allocating revenues, expenses and earnings based on volume of activity in California, absent supportable allocation metrics, indirect expenses for PG&E ET could reasonably be allocated in the same proportion as direct expenses.

- Recalculating PG&E ET’s California earnings based on the proportion of direct expenses, and adding transition expenses to PGE-ET’s estimates of total A&G, interest, depreciation and amortization, and other expenses, results in net income before income taxes and PG&E Corp. allocations for California-related activities of $50.6 million, or 58.3 percent of PG&E ET’s total. A summary of PGE ET’s and the revised estimate of California earnings before income taxes and PG&E Corp. allocations is provided in **Exhibit VII-3**.

Exhibit VII-3
Estimated PG&E ET Net Revenues and Earnings 2000
($ million)

	PG&E ET Total	PG&E California	Percent of PG&E ET Total	BWG California	Percent of PGE ET Total
Power and Gas Revenues	15,499.0	677.7	4.4%	677.7	4.4%
Power and Gas Expenses	(15,333.5)	(629.0)	4.1%	(629.0)	4.1%
Accrual Gross Margin	165.6	48.7	29.4%	48.7	29.4%
Mark to Market Evaluation	72.4	8.1	11.2%	8.1	11.2%
Total Gross Margin	237.9	56.8	23.9%	56.8	23.9%
A&G Exp	(111.1)	(32.7)	29.4%	(4.6)	4.1%
Earnings before Interest, Taxes, Depreciation and Amortization	126.8	24.1	19.0%	52.3	41.2%
Transition Expense	(21.9)		0.0%	(0.9)	4.1%
Interest Income	8.5	2.5	29.4%	0.3	4.1%
Interest Expense	(5.8)	(1.7)	29.4%	(0.2)	4.1%
Depreciation and Amortization	(10.7)	(3.1)	29.4%	(0.4)	4.1%
Other Expenses	(10.1)	(3.0)	29.4%	(0.4)	4.1%
Income (Loss) Before Taxes and PG&E Corp.. Allocations)	**$86.8**	**$18.8**	**21.7%**	**$50.6**	**58.3%**

4. While PG&E Gen. did not have any earnings associated with the California energy markets in 2000, it has several plants under development that will serve California's energy markets, which could have a substantial effect on earnings beginning in 2002.

5. PG&E ES operated in California markets; however, it operated at a loss and was divested in the second quarter of 2000.

    - During the third quarter of 2000, PG&E ES recorded an after-tax charge of $19 million to reflect the closing of transactions to dispose of the retail energy services business and related commodity portfolio.

    - Losses attributable to energy sold in the California markets by PG&E ES are included within the gross margins identified for PG&E ET.

CHAPTER VIII

2000 Federal Income Tax Refund

A. CPUC OBJECTIVE

In defining the scope for this task, the CPUC requested that BWG provide an analysis of the PG&E Corp. 2000 tax return and refund and how it might affect the current cash crisis at PG&E.

B. BACKGROUND

PG&E projects a large tax loss in 2000 because of wholesale power cost increases above retail rate levels in 2000. This is expected to result in a consolidated tax loss to the parent Corporation, PG&E Corp., as well.

As a result of PG&E Corp. consolidated tax losses in 2000, a tax loss carry back to 1998 and 1999 may be available. PG&E Corp. reported total cash payments for income taxes (federal, state and local) of $770 million in 1998 and $723 million in 1999. The current projection is that the 2000 federal income tax return will claim a refund due of $500 million to $1 billion. Tax loss carry backs are not available in California and corresponding refunds of prior years' California income taxes paid are not allowed.

C. EVALUATIVE CRITERIA

BWG utilized the following criteria in analyzing the 2000 tax return:

- What is the status of PG&E's 2000 consolidated federal income tax return?
- How will the PG&E Corp. 2000 tax return and refund affect the PG&E cash crisis?

D. WORK TASKS

During the period from January 22 to January 26, 2001, BWG performed the following tasks:

- Interviewed PG&E Corp. tax, accounting and cash management experts.
- Reviewed published PG&E Corp. and PG&E financial reports.
- Reviewed relevant data request responses.
- Analyzed the potential impact of a 2000 PG&E Corp. tax refund on the cash crisis.

E. FINDINGS AND CONCLUSIONS

1. PG&E Corp. expects to file a 2000 federal income tax return which will claim a refund due of $500 million to $1 billion.
    - PG&E Corp. currently intends to file its consolidated federal income tax return for 2000 between early February and mid-March, much earlier than its normal September filing.
    - The PG&E Corp. consolidated financial statements must be completed for 2000. As of January 25, 2001, PG&E Corp. expected to complete preparation of the statements within days.
    - Additional tax specific information must be collected from the many legal entities that make up PG&E Corp.
    - The complex tax return itself must be completed.
    - PG&E Corp. expects to complete and file the return between early February and early March.
2. There is no statutory or procedural requirement for the Internal Revenue Service (IRS) to pay a requested refund within a specified time frame.
    - Once the return is filed, the IRS will process the return and determine the amount, if any of the refund due.
    - The IRS is currently auditing PG&E Corp.'s 1997 and 1998 tax returns.

- PG&E Corp. plans to make efforts to get the refund for 2000 paid within two weeks of filing the return.

- The refund may arrive as early as late February (early February return filed and refund paid within two weeks) if PG&E Corp. proceeds with its current plan to file the return as soon as possible. However the refund could also be received months or years later if the IRS' review is extended.

- PG&E believes that it is unlikely that reasonably priced borrowing against the expected refund will be available during the current cash crisis.

3. When the refund is paid, it will go directly to PG&E Corp., which files the consolidated return with the IRS.

   - Although the refund will be largely due to losses sustained by PG&E, the tax sharing agreement between PG&E and PG&E Corp. does not have explicit provisions that the cash from the tax refund will be transferred to PG&E. The PGE&E Corp. 10Q report for the third quarter of 2000 shows that zero cash payments for income taxes had been made from PG&E to PG&E Corp. for the first nine months of 2000.

   - PG&E Corp. senior management normally decides how to allocate cash in the Corporate cash pool, including cash from tax refunds.

   - The application of the cash from the eventual refund is not certain at this point.